Cornell Law Review

Volume 26
Issue 4 *June 1941*

Article 7

Corporate Reorganization

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CORPORATE REORGANIZATION

I.

A REVIEW OF THE LAW OF CORPORATE REORGANIZATIONS†

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From the earliest times there have been various laws for the relief of debtors. Such laws were either lenient or severe, depending upon one's status in the economic community. In the twenty-fifth chapter of Leviticus, thirty-fifth verse, we are told:

> "And if thy brother be waxen poor, and fallen in decay with thee; then thou shalt relieve him."

And in the fifteenth chapter of Deuteronomy creditors were admonished not to harden their hearts against debtors. As Max Radin has told us, various general remission laws were passed from time to time, in Rome, among others, the Valerian Law, 86 B.C., which were severely criticized by creditors.[1]

Following the American Revolution, hostility to creditors and to lawyers rose high and there was a great demand for debtor relief laws. Although the Fifth Amendment to the Constitution of the United States provides: "No person shall . . . be deprived of life, liberty, or property, without due process of law; . . . ," Section 8 of Article I of the Constitution gives the Congress power to establish uniform laws on the subject of bankruptcies throughout the United States.

Pursuant to this authority, the Congress has enacted various bankruptcy laws from time to time, but until recently, when laws permitting plans of reorganization binding minorities were adopted, the affairs of large corporations were not rehabilitated under the bankruptcy laws as such.

I. EQUITY RECEIVERSHIPS

In the middle of the last century it became obvious that some method had to be found in order to enable the newly built, but debt-laden, railroads to carry on and yet to relieve them in their inability to meet their debts as they matured. The bankruptcy laws at the time were based upon liquidation only, as are the bankruptcy laws of most countries of the world. Corporations were not insolvent in the bankruptcy sense if the value of their assets exceeded their

†Lecture delivered before the Association of the Bar of the City of New York on March 6, 1941, under the auspices of the Committee on Post-Admission Legal Education.
*Grateful acknowledgement is made to my partners DeLano Andrews and George C. Sharp for many helpful suggestions and to my associates Robert E. Houston, Jr., and Theodore O. Rogers for invaluable assistance in the preparation of this lecture.

[1]*The Nature of Bankruptcy* (1940) 89 U. OF PA. L. REV. 1, 6.

liabilities. They were insolvent in the "equity" sense if they could not meet their debts as they matured. The first equity receivership was granted in 1846.[2] The remedy suggested by Colonel Sellers of Sellersville to issue all railroad bond issues with the first three year's coupons missing would have been simpler but did not meet with public approval.

The old equity receivership was born of necessity during periods of depression when corporations found need for a spell of "sitting under the chancellor's umbrella and watching the weather outside."[3] The federal courts, in the absence of congressional legislation, with the aid and ingenuity of the financial bar, created the necessary judicial procedures. Reversing the old equitable form of converting the property of the debtor into cash for distribution to his creditors, they took possession of the property of the debtor and administered it for the benefit of his creditors until the property could be rehabilitated.

A. Procedure

As was outlined in the able series of lectures delivered before the Association of the Bar of the City of New York in 1916-1917 by the late Paul D. Cravath and others,[4] and in the second series of lectures delivered before the Association in 1931 by the late Judge Julius Mayer, Robert T. Swaine and others,[5] the equity receivership took the form of a bill in equity brought by a "foreign creditor" having a claim in excess of $3,000 against the financially embarrassed corporation. The defect in the complaint of there being no judgment and return "nulla bona" was waived by the corporation, which filed an answer admitting the allegations of the complaint. The court then appointed a receiver to administer the properties. Ancillary proceedings had to be brought in all other jurisdictions in which property was located.

Various committees, generally organized by the management or underwriters of the securities, sprang up. These committees without court supervision drew their own deposit agreements, solicited the deposit of securities and formulated plans of reorganization by negotiation and agreement among the various classes of security holders. The pattern, generally speaking, following the appointment of the receiver or receivers, was for one or more of the various mortgage trustees to petition the receivership court for leave to foreclose the mortgage. The foreclosure action or actions were con-

[2]Collins v. Central Bank, 1 Ga. 435 (1846).

[3]Manhattan Rubber Mfg. Co. v. Lucy Mfg. Co., 5 F. (2d) 39, 43 (C. C. A. 2d 1925).

[4]Published in SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND RECAPITALIZATION (1917).

[5]Published in SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND RECAPITALIZATION (1931). See also FINLETTER, PRINCIPLES OF CORPORATE REORGANIZATION IN BANKRUPTCY (1939) 1, *et seq.*

solidated with the original general creditor's bill, and the receivers for the latter were then usually appointed receivers for the mortgage bondholders. Often one of the receivers was the president of the company and the other the representative of the court. Counsel for the debtor in many instances acted as counsel for the receivers, and counsel for the underwriters of securities of the issuer, previously issued, often acted for the reorganization managers or committees.

Following the formulation of a plan by the committees, the court on motion fixed an upset price for the sale of the mortgaged properties. Generally the creditors or reorganization managers bid in the properties, using the deposited mortgage securities as part payment for the foreclosure price, and borrowed or raised enough cash to pay non-assenting or dissenting creditors. An agreement was then entered into with a new corporation created for the purpose, whereby, in consideration for the transfer to it of (1) the properties foreclosed at the foreclosure sale and (2) cash or securities to the extent provided for in the plan, the new corporation would issue its securities in accordance with the reorganization plan. The new corporation paid all expenses of the reorganization, including the fees and expenses of the reorganization managers, the various committees and their counsel. Strictly speaking, these fees and expenses were not subject to the court's approval.

The plans were in theory supposed to be fair and equitable, but in earlier years the courts did not use their full equity powers to supervise the terms of plans. Later some courts could and did exert considerable influence over plans, either through an exercise of their broad equity powers, or by conditioning their approval of the terms of the final decree, such approval being necessary in order to confirm title to the assets in the new corporation free and clear of liens not provided for in the plan.

B. Advantages and Disadvantages

In the case of large corporations, if there were not too many ancillary proceedings, the device of equity receivership had many advantages. The assumption by the court of jurisdiction over the debtor's estate sought to accomplish the following objectives: (1) to stay creditors seeking judgments and execution against the debtor, thus insuring equality of distribution; (2) to give the federal court administering the receivership the exclusive right to entertain all actions to enforce liens on property within its jurisdiction; (3) to enable the court to decree the sale of property of the debtor as an entirety and at one time; (4) to prevent piecemeal liquidation by the exercise of the common law remedy of attachment and execution. The practice was as flexible as the judge's mind, and certain judges acquired great ability in administering properties of large corporations.[6]

However, many features of the equity receivership were criticized: the allegedly collusive nature of its inception; the delays; the disproportionate rate of expenses to debts when applied to small or medium sized corporations; the great opportunity for political patronage in the appointment of receivers and their counsel by judges; the strict self-dictated terms of the deposit agreement; the wiping out of junior security holders by the foreclosure of the mortgage, except to the extent they were allowed to participate in the plan by putting up cash for new securities; the lack of any means of binding dissenters; the necessity for raising cash to pay the non-assenting security holders; the fees paid to reorganization committee members and their counsel without adequate public supervision; the evils attendant upon the solicitation of assents to the plan prior to the time of its submission to the courts; the reluctance of the courts to upset or criticize the accomplishment of many months' or years' work prior to the submission of the plan to it; the inability of minority groups to implement their views or wishes except by being obstructive or being paid as "hold outs"; the lack of any independent agency to advise either the court or the public as to the past history of the debtor, the reasons for its financial sickness, the competence or incompetence and the honesty or dishonesty of the management, possible causes of action against the management, the company's position in the industry, the likelihood of its rehabilitation and the fairness of the plan; and the dominant position which the management or the holders of the common stock, to the possible detriment of senior security holders, played in the reorganization.

There were also purely practical disadvantages in the procedure. Mention has already been made of the necessity, caused by the fact that the receiver had only possession and not title, of bringing ancillary proceedings in each jurisdiction in which the debtor had property. This rendered the procedure so much the more cumbersome and expensive. To some extent this condition was bettered by the addition in 1911 of Section 56 of the Judicial Code giving the court jurisdiction of all railroad property in its judicial circuit. Further, the equity receivership device was dangerous for those who worked to bring the proceedings to a successful culmination, for unless the various committees were successful in putting through their reorganization plan, in obtaining a satisfactory upset price and in setting up the new corporation with sufficient

[6]The flexibility of federal equity receiverships and the skill of the courts in administering the properties brought under their jurisdiction are well illustrated in the present receivership proceedings of the New York, Westchester & Boston Railway Company, pending in the Federal District Court for the Southern District of New York before Judge Knox. In this instance, the equity receivership proceedings have been used in large part for liquidation, rather than reorganization, of railroad properties and have therefore presented many unique problems.

working capital, including cash sufficient to pay the reorganization expenses, there was no way of compensating those who had spent years attempting to effect a reorganization.

Before the *Monon*[7] and *Boyd*[8] cases, to be mentioned later, preferred and common stockholders, whose continued presence in the capital structure may have contributed to the downfall of the debtor, had been permitted to retain control of the reorganized company upon paying a merely nominal price for new securities, even when there was no real equity available for them. This was done by agreement between the senior security holders and the equity holders without making junior security holders a "fair offer" or without offering them "equitable" terms in a "just" reorganization. After the *Monon* and *Boyd* cases, *supra*, unsecured creditors were sometimes provided for by offering them income bonds or other securities which did not necessarily bear a proper relation to the right being sacrificed by them or to the rights reserved by security holders without a present equity.

It was also charged that little or no attention was paid to the valuable emoluments of control accruing to management in the way of directorships, trusteeships, transfer agencyships and registrarships, depositaryships under deposit agreements, committee memberships, underwritings, retentions of counsel, etc.

But perhaps the outstanding fault of equity receiverships was the insufficient judicial control over the reorganization phase of the proceedings, particularly the formulation of the reorganization plan. Earlier mention has been made of the fact that it was first thought to be no part of the court's duty to adjudicate the fairness of the plan. However, the courts slowly began to assume a more important role. In 1917 Judge Hook in *Guaranty Trust Co. v. Missouri Pacific Railway*[9] said that the plan had such a close relationship to judicial action in the proceedings that it was the court's "duty to take cognizance of it and act accordingly." Almost simultaneous with this pronouncement was the action of Judge Mayer in the Aetna Explosives reorganization of formulating his own plan of reorganization and submitting it to the interested parties for their approval.[10] Judicial control over equity receivership was carried to its furthest extent in the celebrated *Phipps*[11] case by the realistic action of Judge Sanborn in enjoining dissenters and approving and enforcing a plan without judicial sale; but there was never a definitive

[7]Louisville Trust Co. v. Louisville, etc., Ry., 174 U. S. 674, 19 Sup. Ct. 827 (1899).
[8]Northern Pac. Ry. v. Boyd, 228 U. S. 482, 33 Sup. Ct. 554 (1913).
[9]238 Fed. 812, 815 (D. C. Mo. 1916).
[10]Graselli Chemical Co. v. Aetna Explosives Co., 252 Fed. 456 (C. C. A. 2d 1918). See Rosenberg, *The Aetna Explosives Case—A Milestone in Reorganization* (1920) 20 Col. L. Rev. 733.
[11]Phipps v. Chicago, R. I. & Pac. Ry., 284 Fed. 945 (C. C. A. 8th 1922). See Rosenberg, *Phipps v. Chicago Rock Island & Pacific Ry. Co.* (1924) 24 Col. L. Rev. 266.

Supreme Court decision on these questions and hence doubt as to the extent of judicial control continued.[12]

C. The Monon *and* Boyd *Cases*

It will be remembered that in the famous *Monon* case the Supreme Court held that a sale under foreclosure should not be confirmed where it appeared that bondholders and stockholders had in collusion engineered the receivership proceedings for the purpose of defeating the claim of one class of unsecured creditors. Some years after the *Monon* case, it was held in the case of *Northern Pacific Railway v. Boyd* that a judicial sale on court order, made subject to a plan of reorganization devised by bondholders and stockholders and eliminating unsecured creditors, was a "mere form," and that a single unsecured creditor for whom "fair and equitable" provision had not been made in the plan could many years later follow the property of the debtor into the hands of the new corporation. The court likened the foreclosure sale and the plan which did not provide for unsecured creditors, though giving an interest to stockholders by agreement with the mortgage bondholders, to a tax sale at which the property is bought in by the owner. In either case the property could not be sold free and clear of the claims of creditors.

The late Adrian H. Joline of New York said in a lecture delivered before the Harvard Law School in 1910:

"The opinion of Justice Brewer in the *Monon* case stands . . . upon the

[12]In In re *New York, N. H. & H. R. R., 16 F. Supp. 504, 510 (D. Conn. 1936),* Judge Hincks, commenting on the question of whether a court of general equity jurisdiction has power in a proper case by decree, without a judicial sale, to approve and enforce a plan of corporate reorganization, said:

"This important question, the Supreme Court seems never to have decided. See First National Bank v. Flershem, 290 U. S. 504, note 7 beginning on page 515, 54 S. Ct. 298, 303, 78 L. Ed. 465, 90 A. L. R. 391. But in Phipps et al. v. Chicago, R. I. & P. Railway Co. (C. C. A.) 284 F. 945, 28 A. L. R. 1184, in a carefully reasoned decision it was held that even without the aid of an enabling statute the court of equity had plenary power without a judicial sale to approve and enforce a plan of reorganization. To be sure, the value of that decision as a precedent is somewhat weakened by the fact that after certiorari had been granted (261 U. S. 611, 43 S. Ct. 363, 67 L. Ed. 826), it was thereafter dismissed by stipulation between the parties (262 U. S. 762, 43 S. Ct. 701, 67 L. Ed. 1221). However, the doctrine has been persistently reaffirmed in the Eighth Circuit. Royal Union Life Ins. Co. v. Gross (C. C. A.) 76 F. (2d) 219; Warner Brothers Pictures, Inc. v. Lawton-Byrne-Bruner Ins. A. Co. (C. C. A.) 79 F. (2d) 804. In effect, I think, the case of Coriell v. Morris White, Inc. (C. C. A.) 54 F. (2d) 255, 260, in the Second Circuit lends support to that conclusion. . . . Thus the holding, essentially as in the cases cited from the Eighth Circuit, was to the effect that a judicial sale may be dispensed with, provided some other arrangement is substituted which guarantees objecting creditors a judicial hearing on the fairness of their treatment under the plan.

"This decision, to be sure, was reversed in National Surety Co. v. Coriell, 289 U. S. 426, 53 S. Ct. 678, 681, 77 L. Ed. 1300, 88 A. L. R. 1231. But the Supreme Court, in reversing the decision, was careful to base its decision not at all upon the proposition that a judicial sale is a prerequisite to a valid reorganization. As to this, it said only, 'the nonassenting creditors were entitled to have the plan and their objections considered in an orderly way, and to a decree based on adequate data.' . . . "

pages of the reports, a dangerous weapon in the hands of guerillas who hang about the outskirts of reorganizations and endeavor to levy tribute as a condition of abating the nuisance of their presence, and that even to this day reorganizers stand in more or less terror of the *Monon* case, and it looms up as a perpetual spectre in their path."

Mr. Cravath, in this lecture referred to above,[13] after quoting the foregoing extract from Mr. Joline's lecture, said, speaking of the *Boyd* case:

"If this were true of the Monon case, may we not say that the spectre of six years ago has now become materialized into a veritable demon incarnate standing across the path of the reorganizer today?"

What would the vivid spectral and demoniac imagination of Messrs. Joline and Cravath do with the decisions rendered by one of Mr. Cravath's former young men, Mr. Justice Douglas, in *Case v. Los Angeles Lumber Co.*[14] and *Consolidated Rock Products Co. v. du Bois*[15] in which he held that: (1) unless senior interests were fully compensated for all rights surrendered, pursuant to the absolute priority rule of the *Boyd* case, the plan of reorganization was unfair *per se;* (2) as against the dissent of a single creditor, the courts had no power to confirm such a plan even though approved by very large percentages of all classes of security holders; and (3) the words "fair and equitable" were "words of art" having the "fixed meaning" in bankruptcy reorganization statutes imparted to those words in the equity receivership reorganizations. But more of these cases anon.

II. 77B Reorganizations

A. Immediate Background

There were, in addition to the fundamental defects of equity receivership proceedings already mentioned, other impelling reasons for the enactment of Sections 77 and 77B of the Bankruptcy Act of 1933 and 1934.

Beginning in 1928, there was a series of Supreme Court statements throwing doubt on "consent" receiverships. The reorganization bar had thought that whatever question had previously existed as to the validity of the "consent" receivership practice had been set at rest by the decision in 1908 of the Supreme Court in Re *Metropolitan Receivership.*[16] But in 1928 the reorganization bar had been severely jolted by the *caveat* uttered by Chief Justice Taft in *Harkin v. Brundage:*

"We do not wish what we have said to be taken as a general approval of the appointment of a receiver under the prayer of a bill brought by a

[13] *Op. cit. supra* note 4.
[14] 308 U. S. 106, 60 Sup. Ct. 1 (1939).
[15] 61 Sup. Ct. 675, 85 L. ed. 603 (1941).
[16] 208 U. S. 90, 28 Sup. Ct. 219 (1908).

simple contract creditor simply because it is consented to at the time by a defendant corporation. The true rule in equity is that under usual circumstances a creditor's bill may not be brought except by a judgment creditor after a return of '*nulla bona*' on execution. When a receiver has been thus irregularly appointed on such a bill without objection, and the administration has proceeded to such a point that it would be detrimental to all concerned to discharge the receiver, the receivership has been permitted to continue because not seasonably objected to (*Pusey & Jones Company v. Hanssen,* 261 U. S. 491, 497, 500; *Re Metropolitan Ry. Receivership,* 208 U. S. 90, 109, 111; *United States v. Butterworth Corporation,* 269 U. S. 504, 513)."[17]

And in 1932 Mr. Justice Cardozo warned that the Supreme Court could not countenance the evils which arise from friendly receiverships which forestall the "normal process of administration in bankruptcy, enabling the tottering business to continue while creditors were held at bay,"[18] and affirmed the principle that receivership is not a remedy to be granted loosely but "is to be watched with jealous eyes."[19] Finally Mr. Justice Brandeis in *First National Bank of Cincinnati v. Flershem* stated:

"All the cases in which this court appears to have exercised this power in aid of reorganization upon the ground of insolvency dealt with railroads or other public utilities where continued operation of the property and preservation of its unity seemed to be required in the public interest."[20]

The effect of these cases was twofold: First, they threw doubt on the "consent" receivership in all reorganizations, and secondly, they seemed definitely to limit the judicial sanction of this procedure to railroads and other utilities when continued operation "seemed to be required in the public interest."

At no time was there a greater need than in the early '30's for some simplified statutory procedure for reorganizing corporations, particularly the numerous small and medium-sized private enterprises which, because of the depression, found themselves in financial difficulties, and as to which the expense of an equity receivership was often prohibitive.

The reasons for the enactment of Section 77B cannot be summarized more briefly or adequately than they were by Mr. Justice Cardozo in *Duparquet. Huot & Moneuse Co. v. Evans:*

"The evils and embarrassments that brought § 77B into existence are matters of common knowledge. Corporations not insolvent in the statutory sense (*United States v. Oklahoma,* 261 U. S. 253, 260, 261), but presently unable to discharge maturing obligations, were without a

[17]276 U S. 36, 52, 48 Sup. Ct. 268 (1928).
[18]Michigan v. Michigan Trust Co., 286 U. S. 334, 345, 52 Sup. Ct. 512 (1932).
[19]Shapiro v. Wilgus, 287 U. S. 348, 356, 53 Sup. Ct. 142 (1932).
[20]290 U. S. 504, 515, 54 Sup. Ct. 298 (1934).

statutory method for winding up their business without a sacrifice of assets. If they had recourse to voluntary bankruptcy, the forms and methods of administration were rigid and often wasteful, leaving little opportunity for cooperative endeavor on the part of all concerned. See Report of Solicitor General Thacher to the President of the United States submitted to the Congress February, 1932; Senate Document 65, 72nd Congress, 1st Session, p. 90. If they held aloof from courts and put their trust in time and effort, there was the danger of disruptive judgments, which would give a preference to a few, with involuntary bankruptcy little, if at all, deferred. The 'equity receivership' flourished in this soil. At the suit of friendly creditors, embarrassed corporations joined in the prayer for the appointment of receivers to stave off other creditors more selfish or impatient, and foster whatever value was latent in the assets. There is little doubt that many of these receiverships were legitimate and helpful. None the less there resided in the practice a capacity for abuses which will be found reflected in the decisions of this and other courts. At times the receivership was used as an instrument of fraud or covin. *Harkin v. Brundage,* 276 U. S. 36; *Shapiro v. Wilgus,* 287 U. S. 348; cf. *First National Bank v. Flershem,* 290 U. S. 504, 517, 518. At times, however fair in its beginnings, it was inordinately prolonged. *Michigan v. Michigan Trust Co.,* 286 U. S. 334. At times it had a tendency to intrench delinquency in power, and to stifle inquiry into acts of waste or spoliation. Whatever the importance of these abuses or the defects of the existing remedies, the demand became insistent for a practice more open, more responsible, more efficiently and closely regulated, and withal more surely valid, under the supervisions of a court of bankruptcy.

"Section 77B, enacted in 1934, was born of that demand. The remedy to be supplanted or more efficiently controlled . . . was the one generally known as an 'equity receivership,' whereby the assets of a corporation were committed to the custody of a court until the time should arrive when they could be returned to the rehabilitated debtor, or if that should be impossible, divided among creditors."[21]

The presence of reorganization legislation in the Bankruptcy Act is anomalous in view of the diverse purposes of bankruptcy and the rehabilitation of corporations. The inclusion of Section 77B (and Chapter X) in the framework of the bankruptcy law is, of course, primarily a matter of constitutional expediency. It was obvious that state legislation would never be adequate, for practical as well as legal and constitutional reasons.[22] Further it has been seen that one of the great defects of equity receiverships was the inability to bind dissenters; federal legislation under the bankruptcy powers, as an early dictum of the Supreme Court in the *Gebhard* case[23] indicated, offered the means of achieving this end.

[21]297 U. S. 216, 218, *et seq.,* 56 Sup. Ct. 412 (1936).

[22]State laws would be superseded by the federal authority when exercised; because of the contract clause limitation state laws could not constitutionally cause dissenters to be bound; jurisdiction ended at state boundaries; and the state courts were not sufficiently versed in reorganization technique. See Finletter, *op. cit. supra* note 5 at 25.

[23]Canada Southern R. Co. v. Gebhard, 109 U. S. 527, 536, 3 Sup. Ct. 363 (1883).

Section 77B, as passed by Congress in 1934, was largely a codification of equity receivership procedure with particular attention to the more glaring defects of that method. It would be futile to outline the procedure followed under Section 77B. It has now been entirely superseded by Chapter X of the Bankruptcy Act of 1938, which provides a somewhat similar, though in certain respects more complex, procedure, as will be mentioned later. An outline of Section 77B's advantages and disadvantages may prove interesting.

B. Advantages and Disadvantages of Section 77B

Despite its comparatively short life, Section 77B possessed many factors of undoubted merit. It was no longer necessary to show that the debtor was insolvent in the bankruptcy sense. It was sufficient that there was an inability to meet obligations as they matured. Dissenters were bound to accept the terms of the plan upon the approval of two-thirds of each class of creditors and, if the corporation was solvent, a majority of each class of stockholders. The court was given exclusive jurisdiction of the debtor's property wherever located, thus eliminating the necessity of ancillary proceedings. Court control of the proceedings, the lack of which was the major defect of equity receiverships, was extended. The plan, before becoming effective, had to receive court confirmation and such confirmation could occur only if the judge was satisfied that the plan was "fair, equitable and feasible." The court was required to scrutinize, and was empowered to disregard, limitations or provisions of depositary agreements, indentures and of committee proxies or other authorizations. Compensation and expenses were placed under supervision by the simple expedient of requiring court allowance. Individual creditors and stockholders were given the protection of the right to be heard on most questions affecting them.

Another important advantage of 77B was the fact that it was expeditious and practical and the procedure relatively simple. The debtor as well as certain classes of creditors could file a petition and propose a plan; the court had discretion to leave the management in control; and the assents of creditors whose rights would not be affected by the plan were not required.

The defects of Section 77B were centered primarily around the lack of sufficient protection for the independent investor. Some of these defects were: (1) plans were still formulated and negotiated between the various classes of security holders without the court participating directly therein, so that the plan when submitted to the court was largely a *fait accompli;* (2) assents to plans could still be solicited prior to the time the court had passed upon the plan; (3) there was no control of the proxy procedure; (4) there was still no provision for an independent agency to advise the court or the security holders as to the plan's fairness or feasibility and to investigate possible mismanagement and causes of action which might belong to the debtor; (5) the court could still leave the debtor in possession even when a continuation of the old management might lead to abuses; and (6) those with conflicting interests often had too much to say in the formulation of plans.

III. Chapter X Reorganizations

A. Immediate Background

In May of 1937 the Securities and Exchange Commission, through one of the ablest judges and pamphleteers of our generation, Mr. Justice (then Commissioner) Douglas, pursuant to the provisions of Section 211 of the Securities Exchange Act of 1934, began issuing its reports to the Congress on the strategy and techniques of reorganization committees. In these reports, invaluable to the student of reorganization, the Securities and Exchange Commission attacked current practices in receivership, foreclosure, bankruptcy and voluntary reorganizations on the ground that they were often perverted and served the interests of the reorganizers in opposition to the interests of the investors. The reports denounced the motives of many reorganizers as seeking the emoluments of control rather than the interest of investors, and in general pointed out all of the glaring inequalities of the equity receivership method and all of its disadvantages without admitting its many advantages and benefits, thus achieving much the same result as Katherine Mayo did in "Mother India." The report did, however, recognize that in any reorganization "claims of dubious legality may have to be recognized and awarded participation in the plan so as to avoid expensive and time-consuming law suits," and that concessions entailing "some sacrifice of fairness in the interest of expediency, economy, and thoroughness" could be made.[24]

As a result of Solicitor General Thacher's Report,[25] the experience in Sections 77 and 77B, the long and valuable work by a special committee of this Association, the work of the American Bar Association, the National Bankruptcy Conference, the National Creditmen's Association and the able and effective help of Representative Chandler of Tennessee, and later of Senator O'Mahoney of Wyoming, and of the Securities and Exchange Commission, Congress passed in June 1938 a complete revision of the Bankruptcy Act of 1898.[26] It is with Chapter X of the Bankruptcy Act of 1938, permitting the financial rehabilitation of financially ill corporations, and also to some extent with Chapter XI permitting the adjustment of the affairs of a corporation having only unsecured debts, that we are chiefly concerned.

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[24]Securities and Exchange Commission Report, Pt. I, pp. 3, 4.
[25]Report to the President, dated Dec. 5, 1931, 72nd Congress, 1st Session, Sen. Doc. 65.
[26]52 Stat. 840, *et seq.* (1938), 11 U. S. C. A. (Supp. 1940) § 1, *et seq.* Hereinafter referred to only by the numbers of pertinent sections.

B. Changes Effected by Chapter X

Chapter X throws many more safeguards around the investor than did the previous equity receivership proceedings or the proceedings under Section 77B. It has been called the "democratization" of reorganization procedure. Undoubtedly this is due in some measure to the dominating influence of Mr. Justice Douglas, then a member of the Securities and Exchange Commission, to the fact that those who had successfully opposed a plan could not be compensated and to the fact that the bankruptcy bar always looked with longing eyes at the financial plums supposedly to be picked from the reorganization Christmas tree.

In case the liquidated indebtedness of the debtor exceeds $250,000 the reorganization court must appoint a trustee completely divorced from interest in or present or previous relationship with the issuer or its underwriters.[27] Mention has been made of the fact that often in equity receivership someone close to the old management was appointed receiver and that under 77B the court in any case could continue a debtor in possession. The proscription of these practices by the requirement of the appointment of a disinterested trustee was emphasized by the S. E. C. as the most important of the proposed reforms.[28]

The trustee's duties are not limited to its care of the debtor's property. He is also required, if so directed by the court, to investigate the affairs of the debtor and those connected with it for the purpose of gathering information helpful in the formulation of a plan and of unearthing possible causes of action.[29] The trustee is also charged in the first instance with the responsibility of preparing and submitting a plan,[30] thus bringing this most important of all features of the reorganization under the control and supervision of the court. All this means, of course, that the rôle played by management and committees has become much less important.

The trustee is now expressly vested with title to the debtor's property as of the date of the filing of the petition.[31] Section 70 d (1) of the Act, applicable to reorganizations, provides that transfers by the debtor after the filing of the petition shall be void unless made to a person in good faith and for fair value. This section, when read with Section 70 d (3) which declares that a person having actual knowledge of the pending bankruptcy shall not be deemed to act in good faith, may make control by a corporation over its property between filing of the petition and adjudication somewhat difficult. Indeed, it is quite possible that these provisions, if applied strictly, would, pending adjudication under Chapter X, prevent the carrying on of business by the debtor and might make banks reluctant to honor its checks; it would certainly curtail transactions with persons aware of Section 70. This flaw in the Act

[27] § 156.
[28] SECURITIES AND EXCHANGE COMMISSION REPORT, Pt. I, p. 899.
[29] § 167. [30] § 169. [31] § 70(a).

is one which will probably require congressional attention. The right to the immediate possession of the debtor's property is vested in the trustee and includes property held by a trustee under a deed of trust or by a mortgagee.[32]

The second major change effected by Chapter X is the injection into the proceedings of the Securities and Exchange Commission as the guardian of the interests of the public and the particular investors involved. If the indebtedness of the corporation exceeds $3,000,000, the court must, and if less than $3,000,000, it may, submit the plan or plans proposed to the Commission for an advisory report thereon.[33] Further, though the Commission's recommendations do not have to be followed, the court may not approve a plan until the report is filed, unless it appears that such a report will not be forthcoming.[34] The Commission must be notified of practically all steps in the proceedings, and is given the further right to intervene and be heard as a party in interest though it is not given any right of appeal.[35]

Another important change effected is the still further broadening of the court's control of the proceedings. Many bankruptcy features have been brought into Chapter X[36] and the court, through the liberal use of referees in bankruptcy or special masters which has been expressly permitted,[37] has been enabled to inform itself fully in every phase of the proceedings. Furthermore, persons or committees representing more than twelve creditors or stockholders are required to file sworn statements with reference to the agreements under which they operate and the claims which they represent.[38] The court may disregard assents or dissents to the plan which have been lodged in bad faith.[39] The court's power to disregard provisions in deposit agreements, trust indentures and committee authorizations, granted in 77B, is retained and somewhat enlarged,[40] and the fact that no solicitations of acceptances to a plan

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[32] § 257.

Section 113 gives the judge the power prior to the approval of the petition to grant a temporary stay of, *inter alia,* any proceeding to enforce a lien against the debtor's property or the commencement or continuation of a suit against the debtor. This section removes the doubt that existed under 77B as to the Court's power to issue temporary stays and injunctions prior to the approval of the petition. See Gerdes, *Corporate Reorganization: Changes Effected by Chapter X of the Bankruptcy Act* (1938) 52 HARV. L. REV. 1.

In In re *Philadelphia and Reading Coal & Iron Co., C. C. H. Bankruptcy Service,* ¶ *53,056 (C. C. A. 3rd 1941),* the trustee under a mortgage covering securities owned by the debtor petitioned the bankruptcy court to have the debtor pay over to it dividends and interest received by the debtor from the issue of the securities. Under the terms of the mortgage the mortgage trustee was entitled to the income from the pledged securities after default. The court held that the right of the mortgage trustee to receive the income must yield to the necessity of preserving intact the business and property of the debtor to the extent reasonably necessary to afford an opportunity for reorganization. In answer to the contention that the debtor had ample other funds with which to carry on its business pending reorganization, the court pointed out that the necessities of a debtor in reorganization are often uncertain and that a wide discretion must be vested in the court with regard to applications such as a petition for the turning over of interest payments.

[33] § 172. [34] § 174. [35] § 208.

[36] Section 102 makes Chapters I to VII of the Act applicable to reorganization proceedings.

[37] § 117. [38] § 211. [39] § 203. [40] § 212.

may be made before approval, except with the consent of the court,[41] has given the court a freer hand in dealing with the plan or plans presented.

Article XIII is devoted to the subject of allowances and greatly broadens the provisions of Sections 77 and 77B as to the number of persons and their counsel who are entitled to apply for compensation and expenses. It is obvious that certain sections of Article XIII were drafted to meet the rules laid down in In re *Paramount-Publix Corporation*[42] where the court refused compensation to attorneys representing individual bondholders, where bondholders were deemed to be adequately protected by committees already in the field. The subject of allowances and some of the recent cases will be discussed later.

It is not possible, of course, to refer here to all the detailed provisions of Chapter X. Nor does it seem necessary. The Act itself is well drafted and in general very clear. It is assumed that the reader has read it and will not welcome a paraphrase of its provisions. Also, there have been a number of excellent law review articles written on the subject which ably supplement the provisions of the Act.[43]

C. Chapter X Procedure

In broad outline, the procedure to be followed under Chapter X is as follows:

A corporation or three or more of its creditors who have claims aggregating at least $5,000 or an indenture trustee in certain instances[44] may file the reorganization petition with the court in whose territorial jurisdiction the corporation has had its principal assets or principal place of business for the preceding six months or for a longer portion of the preceding six months than in any other jurisdiction. The petition must meet certain requirements, particularized in the Act, and be filed in "good faith." The provisions as to filing answers have been broadened and clarified.[45] If the court approves the

[41]§ 176.

[42]85 F. (2d) 588 (C. C. A. 2d 1936), *cert. denied,* 300 U. S. 655, 57 Sup. Ct. 432 (1937).

[43]See especially Israels, *On Problems of Policy and Procedure in the Conduct of Reorganization Proceedings* (1940) 89 U. OF PA. L. REV. 63; Heuston, *Corporate Reorganizations Under the Chandler Act* (1938) 38 COL. L. REV. 1199; Gerdes, *Corporate Reorganizations: Changes Effected by Chapter X of the Bankruptcy Act* (1938) 52 HARV. L. REV. 1; Gerdes, *General Principles of Plans of Reorganization* (1940) 89 U. OF PA. L. REV. 39. For discussion of tax problems in reorganization see Darrell, *Discharge of Indebtedness and the Federal Income Tax* (1940) 53 HARV. L. REV. 977; Warren and Sugarman, *Cancellation of Indebtedness and Its Tax Consequences* (1940) 40 COL. L. REV. 1326, and (1941) 41 COL. L. REV. 61; Surrey, *The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness* (1940) 49 YALE L. J. 1153; Paul, *Debt and Basis Reduction under the Chandler Act* (1940) 15 TULANE L. REV. 1.

[44]One of the interesting features of the new legislation is the broadened powers of the indenture trustee. See Sections 126, 131, 161, 179, 198, 206.

[45]See generally Article VI.

petition, it then appoints one or more trustees or, if the indebtedness is less than $250,000, the debtor may be left in possession. A time is fixed for a hearing on whether the trustee is qualified (or on whether the debtor should be allowed to continue longer in possession). After this hearing, the trustee, or if there be none, a court appointee, makes his investigation of the property and affairs of the debtor and prepares his report. The trustee is also given a period of time in which to formulate a plan, the debtor or any creditor or stockholder being permitted to submit objections or amendments or other plans. When the trustee's plan has been formulated, a hearing is held on such plan (and on any objections or amendments or other plans proposed as above mentioned), after which, if the indebtedness exceeds $3,000,000, the plan or plans must be submitted to the Securities and Exchange Commission for advisory report. If the court is satisfied as to the fairness, the equitableness and feasibility of a plan and that it complies with other provisions of the Act, it will approve the plan. The plan or plans so approved, together with the Securities and Exchange Commission's advisory report and the judge's opinion, are then submitted to the creditors and stockholders affected for acceptance. If accepted by two-thirds in amount of claims filed and allowed[46] (the importance of the phrase "filed and allowed" is emphasized later in the discussion under possible amendments) and, in case the debtor is not insolvent, by a majority of stockholders, the court fixes a time for hearing on the confirmation of the plan. At this hearing all interested parties are given a final chance to object. After this hearing the court must confirm the plan, if satisfied that it is fair, equitable and feasible.

Let us examine the meaning of these "words of art," "fair, equitable and feasible." Obviously a plan of reorganization which failed entirely to observe the relative rights of the creditors and stockholders would not be fair, equitable and feasible. The question remains, however, as to how radical the readjustments can be without violating the rule. We have seen that even under equity receivership, where the formulation of the plan was left to dealings among the claimants, there were the limitations of the *Monon* and *Boyd* cases; stockholders could not be given a share if unsecured creditors had been neglected. But these cases did not settle the question of whether the preservation of priorities was required to be mathematical and absolute or could be practical and relative; and, further, they had been decided before the enactment of the reorganization legislation. This was particularly true in cases arising out of Section 77 and Section 77B because of the fact that these sections were originally designed for the "relief of debtors." With the passage of Sections 77 and 77B and later of Chapter X there arose the question as

[46]See *infra* p. 588.

to whether the statutory language, "fair, equitable and feasible" meant to incorporate the rule of the *Monon* and *Boyd* cases, or whether, in view of the fact that the court was given wide powers over the plan, the principle was no longer applicable and a less rigid standard might be invoked. Any doubt on these scores has been set at rest by the *Los Angeles Lumber Co.* and *Consolidated Rock Products Co.* cases, to which reference will now be made.

D. Los Angeles Lumber Co. Case

A case of which you will undoubtedly hear again and again and with which anyone seeking to reorganize a corporation must be thoroughly familiar is that of *Case v. Los Angeles Lumber Products Co.*[47] The debtor, a holding company, owned all of the shares of Los Angeles Shipbuilding and Drydock Corporation, having total assets of about $830,000. The debtor's liabilities amounted to approximately $4,500,000. At the time that the plan of reorganization was proposed, the debtor had outstanding approximately $3,800,000 in 6% income bonds, 57,788 shares of Class A stock and 5,112 shares of Class B stock. Its capitalization was the result of a voluntary recapitalization effected in 1930, pursuant to which the bondholders gave up the right of foreclosure until 1944.

In 1937 the debtor went into 77B and proposed a plan whereby the bondholders would receive 641,375 shares of preferred stock and the Class A stockholders would receive 188,625 shares of common stock. No provision was made for the Class B stockholders. The plan was assented to by approximately 92.8% of the face amount of the bonds, 99.75% of the Class A Stock and 90% of the Class B stock. The petitioners, who owned $18,500 face amount of the bonds, objected to the plan as not being fair and equitable to the bondholders.

The District Court confirmed the plan, and the Circuit Court of Appeals affirmed, apparently on the grounds (1) that the relative priorities were preserved by virtue of the preferences accorded to the stock received by the bondholders, and (2) that the stockholders had furnished "compensating advantages," the principal one of which consisted in giving up their right to prevent foreclosure and thus manage the debtor until 1944.

The Supreme Court, in reversing the Circuit Court of Appeals, held that since the debtor was insolvent, the proposed inclusion of stockholders in the reorganized company made the plan unfair and inequitable as a matter of law. After analyzing the *Boyd* case and the *Kansas City Terminal*[48] case, the Court stated, with respect to participation by stockholders:

> "In view of these considerations we believe that to accord 'the creditor his full right of priority against the corporate assets' where the debtor is

[47] 308 U. S. 106, 60 Sup. Ct. 1 (1939).

[48] Kansas City Terminal Ry. v. Central Union Trust Co., 271 U. S. 445, 46 Sup. Ct. 549 (1926).

insolvent, the stockholders' participation must be based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholders."[49]

As to the conclusion of the District Court that the "virtual abrogation of the agreement deferring foreclosure until 1944 justified participation by the stockholders in the plan," Mr. Justice Douglas pointed out that any such right to delay foreclosure had been waived by invoking the jurisdiction of the federal courts under Section 77B.[50]

Thus, the United State Supreme Court has made it clear that the terms "fair and equitable" in Section 77B of the Bankruptcy Act require that the reorganization plan of an insolvent corporation must provide complete priority for senior securities before junior securities may participate in the reorganized enterprise[51] and that value must be determined by capitalizing "reasonably prospective earnings." This is referred to as the "absolute priority rule," originally laid down in the *Monon* and *Boyd* cases.

However, even after the decision in the *Los Angeles Lumber Co.* case, certain questions as to the application of the "absolute priority rule" still remained doubtful. The opinion of Mr. Justice Douglas did not state whether the rule applied to solvent as well as insolvent corporations. Nor did the opinion cover the question as to whether the several legal priorities of the different classes of creditors must be preserved in the respective classes of new securities to be issued by the reorganized company.

In *Taylor v. Standard Gas and Electric Co.*,[52] the Supreme Court held that the parent corporation, Standard Gas and Electric Company, which was owed certain open account indebtednesses by a subsidiary company in processes of

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[49]308 U. S. at 122.

[50]"The right to remain in unmolested dominion and control over the property was necessarily waived or abandoned on invoking the jurisdiction of the federal courts in these proceedings. When that jurisdiction attached, the court rather than the stockholders was in control with all of the powers and duties which that entailed under § 77B. Certainly the surrender of a right thus waived is not adequate consideration for the dilution of the bondholders' priorities which this plan would effect." *Id.* at 127.

[51]See the excellent article by Professor Dodd, *Los Angeles Lumber Products Co. Case and Its Implications* (1940) 53 HARV. L. REV. 713. In summarizing the Supreme Court's opinion, Professor Dodd stated, at page 719:

"The opinion establishes three propositions: (1) That the words 'fair and equitable' in Section 77B are words of art which have the same meaning which they had acquired in equity reorganizations and include '*inter alia,* the rules of law enunciated by this (Supreme) Court in the familiar case of (*Chicago, R. I. & P.*) *Railroad Co. v. Howard,* 7 Wall. 392, *Louisville Trust Co. v. Louisville, N. A. & C. Ry. Co.,* 174 U. S. 674; *Northern Pacific Ry. Co. v. Boyd,* 228 U. S. 482; *Kansas City Terminal Ry. Co. v. Central Union Trust Co.,* 271 U. S. 445'; (2) that the doctrine of those cases is now interpreted as a 'principle of full or absolute priority' of creditors which 'will not permit valueless junior interests to perpetuate their positions on . . . ephemeral grounds'; and (3) that the alleged consideration given by the shareholders in the instant case, including their surrender of the right to postpone foreclosure until 1944, was not of such a character as to justify their participation in the reorganized enterprise."

[52]306 U. S. 307, 59 Sup. Ct. 543 (1939).

reorganization under Section 77B, should have been treated as a mere common stockholder and subordinated to the preferred stockholders. As to the priority to be accorded to the preferred stockholders, Mr. Justice Roberts stated:

> "If a reorganization is effected the amount at which Standard's claim is allowed is not important if it is to be represented by stock in the new company, provided the stock to be awarded it is subordinated to that awarded preferred stockholders. No plan ought to be approved which does not accord the preferred stockholders a right of participation in the equity in the Company's assets prior to that of Standard, and at least equal voice with Standard in the management. Anything less would be to remand them to precisely the status which has inflicted serious detriment on them in the past."[53]

It seemed from this decision, therefore, though not entirely clear, that the "absolute priority rule" applied to solvent as well as insolvent corporations and that preferred stockholders and creditors must be given rights in the assets of the reorganized company prior to those given to common stockholders even where the latter are properly permitted to participate in the plan.

It was further argued by some, on the basis of the language used by Mr. Justice Roberts, that it is not enough to preserve relative priorities by increasing the quantity or the quality of new junior securities, but that relative priorities as to earnings must also be preserved. Thus the question was raised as to whether there could ever be a fair and equitable plan which gave only one class of securities to all security holders. Obviously, if relative priorities as to earnings had to be preserved, it would mean that no capital structure, however complex, could be simplified except through the elimination of such junior classes as were found to have no equity in the assets. And where there was some equity for junior classes of security holders, there would be no alternative except to preserve the same complicated capital structure that may have aided in bringing the debtor to its difficulties.

Yet in *Kansas City Terminal Railway Co. v. Central Union Trust Co.*,[54] the Supreme Court had held, before the enactment of Section 77B, that a plan may be fair and equitable in an equity receivership under the rule in the *Monon* and *Boyd* cases even though the unsecured creditors are given the same class of securities as stockholders, provided the creditors are given compensating advantages (the difference there being that the stockholders were made liable to greater assessments). The decision in this case seemed to support the view that under the "absolute priority rule" senior security holders can be given a greater quantity of new securities of the same quality as is given to the junior security holders.[55]

[53] *Id.* at 324.
[54] 271 U. S. 445, 46 Sup. Ct. 549 (1926).
[55] Compare S. E. C. Holding Company Act Release No. 1803, *In the Matter of Com-*

E. Consolidated Rock Products Co. Case

All such remaining questions as to the meaning of the "absolute priority rule" of the *Boyd* and *Los Angeles Lumber Co.* cases have been resolved by the recent decision of the Supreme Court in the *Consolidated Rock Products Co. v. du Bois.*[56] The facts may be summarized as follows:

The parent company, referred to as "Consolidated," had two wholly-owned subsidiaries, Union Rock Co., referred to as "Union," and Consumers Rock and Gravel Co., referred to as "Consumers." Union had outstanding $1,877,000 of 6% bonds with accrued and unpaid interest of $403,555. Consumers had outstanding $1,137,000 of 6% bonds with accrued and unpaid interest of $221,715. Consolidated had outstanding 285,947 shares of preferred stock and 397,455 shares of common stock. Since 1929, when Consolidated acquired control of Union and Consumers, all the properties of the parent and the two subsidiaries had been operated as a unit by Consolidated, pursuant to an operating agreement, resulting in a "commingling" of such properties. Consolidated's books showed a net indebtedness under such operating agreement of over $5,000,000 to the two subsidiaries.

Consolidated, Union and Consumers all filed petitions for reorganization under Section 77B of the Bankruptcy Act. A plan was proposed providing for the transfer of all of the properties of Consolidated, Union and Consumers to a new company, the intercompany claims owing from the parent to the subsidiaries to be cancelled and the securities of the new company to be distributed as follows:

> Union and Consumers bondholders to receive 50% of the principal of their respective bonds in new income bonds secured by a mortgage on all of the property of the new company, and the remaining 50% in an equal amount of par value preferred stock, their claims for accrued interest on the bonds to be extinguished;
>
> The preferred stockholders of Consolidated to receive one share of new common stock, $2 par value, for each share of old preferred; and
>
> The common stockholders of Consolidated to receive a warrant to purchase one share of new common for $1, within three months of issuance, for each five shares of old common.

On the basis of valuations submitted, the District Court found the fair value

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munity Power & Light Co., dated November 27, 1939. The plan, which the Commission found to be fair and equitable, provided in substance for an exchange of new common stock for the two classes of stock then outstanding, namely, preferred and common. The Commission concluded that even from the standpoint of the preferred stockholders the plan was beneficial, stating that the company's history and earnings indicated that a preferred stock issue would not be financially sound.

[56] 61 Sup. Ct. 675, 85 L. ed. 603 (1941).

of all the assets to be in excess of the total bonded indebtedness, but insufficient to pay such indebtedness plus liquidation preferences and accrued dividends on Consolidated preferred stock. It also found that the fair value of assets subject to the Union and Consumers mortgages was insufficient to pay the principal and accrued interest of the respective bond issues. However, the District Court did not find specific values for the separate properties of Consolidated, Union or Consumers, or even for the properties of the enterprise as a unit. Nor did it make findings as respects the amount or validity of the $5,000,000 intercompany claim of the subsidiaries against the parent.

The plan was confirmed by the District Court and an appeal taken to the Circuit Court of Appeals. The Circuit Court of Appeals affirmed the District Court and two days later the Supreme Court handed down its decision in the *Los Angeles Lumber Co.* case. Motion for reargument was granted and the Circuit Court of Appeals, on the basis of the *Los Angeles Lumber Co.* case, held that the District Court had erred in confirming the plan.

The Supreme Court (Mr. Justice Douglas) unanimously affirmed the decision of the Circuit Court of Appeals, on the following grounds:

First, that since the necessary valuation data was lacking, no determination of the fairness of a plan could be made, valuation of assets being essential in order to apply the "full and absolute priority rule" of the *Boyd* case and the *Los Angeles Lumber Co.* case. With respect to the valuation problem, Mr. Justice Douglas stated:

> (a) that there should have been a finding as to the assets subject to the payment of the respective claims, including the $5,000,000 intercompany claim, since otherwise appropriate allocation of the new securities between bondholders and stockholders, and between bondholders *inter sese,* could not possibly be made; and
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> (b) that a valuation of productive properties should be made by capitalizing prospective earnings, earning capacity being based on all the relevant facts in a particular case.[57]

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[57]Mr. Justice Douglas pointed out in this connection:

"Findings as to the earning capacity of an enterprise are essential to a determination of the feasibility as well as the fairness of a plan of reorganization. . . . It is also essential for satisfaction of the absolute priority rule of Case v. Los Angeles Lumber Products Co. . . . Unless meticulous regard for earning capacity be had, indefensible participation of junior securities in plans of reorganization may result. * * *

"Since its application requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earnings record, and all circumstances which indicate whether or not that record is a reliable criterion of future performance." 61 Sup. Ct. at 85.

As Mr. Justice Brandeis said in *State of Missouri,* ex rel., *Southwestern Bell Telephone*

Second, that the "absolute priority rule" applies to reorganizations of solvent as well as insolvent corporations, that "full compensatory provision" must be made for all rights which creditors surrender. Accordingly, the plan in this case was unfair because the bondholders received nothing for the accrued and unpaid interest on their bonds and also because they were given nothing to make up for receiving an inferior grade of securities for the principal amount of their bonds. The Court expressly pointed out, however, that so long as creditors receive "full compensation" for "the entire bundle of rights" surrendered, they may be given the same grade of securities as are received by junior interests, the method of effecting such full compensation depending on the particular facts of each case:

> "The absolute priority rule does not mean that bondholders cannot be given inferior grades of securities, or even securities of the same grade as are received by junior interests. Requirements of feasibility of reorganization plans frequently necessitate it in the interests of simpler and more conservative capital structures. And standards of fairness permit it. This was recognized in *Kansas City Terminal Ry. Co. v. Central Union Trust Co.*, 271 U. S. 445. [Quoting at length from the *Kansas City Terminal* case.] . . .
>
> "Practical adjustments, rather than a rigid formula, are necessary. The method of effecting full compensation for senior claimants will vary from case to case."[58]

The decision of the Circuit Court of Appeals, however, in applying the "absolute priority rule" had apparently gone beyond the question of the paramount rights of creditors over stockholders and had indicated that the plan was unfair, not only because of the participation of stockholders, but also because the Union and Consumers bondholders had been compelled to give

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Company v. Public Service Commission of Missouri, 262 U. S. 276, 310, 43 Sup. Ct. 544 (1922), "Value is a word of many meanings." As an example of the swing in the Court, see *Connecticut Railway Co. v. Palmer, 305 U. S. 493, 59 Sup. Ct. 316 (1939).* Here it was a question of the measurement of damages for future rent claims under Section 77. The Supreme Court held it error to limit the damages to those accruing to the time of the last hearing and remanded to the District Court to fix damage based on "evidence which satisfies the mind." On appeal from the decision of the District Court which held proof offered not acceptable and struck down the claim including claim allowed on former hearings, the Supreme Court, *61 Sup. Ct. 379, 85 L. ed. 283 (1941),* held that proof of future profits by the evidence of past profits is a reasonable means of reaching a valuation, the majority finding damages for eleven years might be predicted with a fair degree of certainty. Mr. Justice Frankfurter dissented, urging that case be remanded to ascertain damages "on a tough business basis." Mr. Justice Douglas, with whom Mr. Justice Black concurred, dissented on the grounds that the evidence presented was inadequate to establish damages under the Court's earlier ruling, Mr. Justice Douglas holding the more pertinent test to be that of future earnings based on estimates of future population trends, competitive conditions, etc., and contending that the problem involved was probably not different from that of valuing a fee interest, so that conventional rules governing appraisals of the worth of such interests would be applicable.

[58]61 Sup. Ct. at 686.

up their separate liens on the respective properties of the two subsidiaries. Obviously, such a decision if allowed to stand would make some of the larger reorganizations exceedingly difficult, if not impossible, and would even upset most of the railroad reorganization plans already approved by the Interstate Commerce Commission. Thus, on the application for a writ of certiorari, both the Securities and Exchange Commission and the Interstate Commerce Commission filed memoranda with the Supreme Court urging that the case be accepted for review, particularly because of the question involved as to "the authority of the reorganization court to approve a plan which substitutes one mortgage covering all of the property for so-called divisional mortgages on separate units of that property."[59]

Because of the importance of this aspect of the case, therefore, the Supreme Court went out of its way to make it clear that a plan is not unfair *per se* merely because separate bond issues are not permitted to retain their respective liens on the specific properties involved.[60] Stressing the requirements of feasibility, the Court pointed out that "there is no necessity to construct the new capital structure on the framework of the old" (that is, so long as creditors are "adequately compensated for the loss of their prior claims").

F. *General Comments on Application of "Absolute Priority Rule"*

The basic doctrine of the so-called "absolute priority rule" is not new and should not be shocking to the bar. As already mentioned, it springs directly from the *Monon* and *Boyd* cases, in the old equity receivership reorganizations. It is the extent to which the Supreme Court has gone in the *Los Angeles Lumber Co.* case and the *Consolidated Rock Products Co.* case in applying this doctrine that is significant. The decisions go beyond the fact that bondholders *may*, if the corporation is insolvent, eliminate the stockholders. They direct

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[59]See Mr. Justice Douglas' opinion, n. 2, 61 Sup. Ct. at 680.

[60]"The Circuit Court of Appeals, however, made certain statements which if taken literally do not comport with the requirements of the absolute priority rule. It apparently ruled that a class of claimants with a lien on specific properties must receive full compensation out of those properties, and that a plan of reorganization is *per se* unfair and inequitable if it substitutes for several old bond issues, separately secured, new securities constituting an interest in all of the properties. That does not follow from *Case v. Los Angeles Lumber Products Co.* . . . If the creditors are adequately compensated for the loss of their prior claims, it is not material out of what assets they are paid. So long as they receive full compensatory treatment and so long as each group shares in the securities of the whole enterprise on an equitable basis, the requirements of 'fair and equitable' are satisfied.

"Any other standard might well place insuperable obstacles in the way of feasible plans of reorganization. Certainly where unified operations of separate properties are deemed advisable and essential, as they were in this case, the elimination of divisional mortgages may be necessary as well as wise. Moreover, the substitution of a simple, conservative capital structure for a highly complicated one may be a primary requirement of any reorganization plan. There is no necessity to construct the new capital structure on the framework of the old." 61 Sup. Ct. at 687.

that the bondholders have no choice, as against a single dissent, and *must* do so. Questions of solvency or insolvency must be litigated. Moreover, it is apparently just as unfair *per se*, under these cases, to give the senior security holders any equity belonging to the stockholders, against the dissent of any stockholder, as it is to allow the stockholders to share in the assets of an insolvent corporation against the dissent of a single creditor.[61] In other words, the senior security holder, whom we may designate as "Shylock," may have his pound of flesh but not a drop of the junior security holder's blood and the junior security holder may have his drop of blood but may not retain a shred of the pound of flesh.

Since the determination of whether or not there is any equity for common stockholders must be based on reasonably prospective earnings, it becomes essential that we arrive at a mathematical formula[62] which may be of exceedingly difficult application, especially in times of depression, for, in addition to determining reasonably prospective earnings, we must arrive at a figure at which those earnings are to be capitalized. It is on these estimates of earnings and the conclusions as to rates of capitalization that an equity security holder may or may not participate in the reorganization.[63]

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[61]As Mr. Justice Douglas stated in the *Consolidated Rock Products Co.* case:

"We have already noted that no adequate finding was made as to the value of the assets of Consolidated. In view of what we have said, it is apparent that determination of that value must be made so that criteria will be available to determine an appropriate allocation of new securities between bondholders and stockholders in case there is an equity remaining after the bondholders have been made whole." 61 Sup. Ct. at 684.

[62]In the *Consolidated Rock Products Co.* case, Mr. Justice Douglas terms such formula "an estimate, as distinguished from mathematical certitude." 61 Sup. Ct. at 681. However inexact the formula may be and whatever the terminology used, it would nevertheless seem clear that some sort of mathematical formula must be worked out; DEWING, FINANCIAL POLICY OF CORPORATIONS (3d ed. 1934) 145: "The rate at which a business shall be capitalized, to obtain its value, will depend on the relative certainty or uncertainty, the relative risk, of continuation of the earnings. The greater the risk, the greater the doubt of continued earnings and the lower is the capitalized value of these earnings; and conversely, the lower the risk, the greater the value"; See table at 175. 1 BONBRIGHT, VALUATION OF PROPERTY (1935) 238, 875-881, 883-893; *cf.* Temmer v. Denver Tramway Co., 18 F. (2d) 226 (C. C. A. 8th 1927); *In re* Consolidation Coal Co., 11 F. Supp. 594 (D. Md. 1935); *In re* Wickwire Spencer Co., 12 F. Supp. 528 (W. D. N. Y. 1935); *In re* Chicago Great Western Ry., 29 F. Supp. 149 (N. D. Ill. 1939).

[63]Under the Supreme Court's decision in the *Consolidated Rock Products Co.* case, it would seem that the absolute priority rule requires that the security holders be given new securities with a *market value* equal to the full amount of their respective claims. Thus, in addition to determining the valuation of the property (on the basis of prospective earnings and all other relevant factors), it would appear that some testimony should be introduced as to the probable market value of the new securities to be allocated under the plan. See article on the *Consolidated Rock Products Co.* case by Professor Gerdes, printed in the New York Herald Tribune of March 9, 1941, in which he points out that if a creditor is given new securities which are "worth less than par," he must receive a sufficient additional number of such new securities to give him "a total value equal to the value of his old claim." *Cf.* Friendly, *Some Comments on the Corporate Reorganization Act* (1934) 48 HARV. L. REV. 39, 77-78. This view is further supported by the recent Advisory Report (Reorganization Release No 41, .March 29, 1941) of the Securities and Exchange

Thus, the Commission and the courts in cases arising under Chapter X must rule that one cannot take something of value from a senior security holder and give it to junior security holders without full compensation irrespective of how overwhelming the vote may be in favor of any plan containing such a provision. In fact, even though the great bulk of security holders of an allegedly insolvent corporation may wish to grant the stockholders something in order to avoid litigating the question of solvency, and even though the plan may be otherwise fair and equitable, the entire reorganization may be jeopardized by a single non-assenting creditor, unless the stockholders can prove that they are contributing full value for the new securities allocated to them. At least these results would seem to flow from a strict and literal enforcing of contractual superiority and liquidating preferences. It is, of course, difficult to quarrel with the reasoning in the *Los Angeles Lumber Co.* and *Consolidated Rock Products Co.* cases on the basis of the facts in those cases.

It is true that the opinion in the *Los Angeles Lumber Co.* case recognizes that a reorganization court may sanction settlements in situations which "give rise to honest doubts as to which security holders may have first claim to certain assets."[64] And likewise in the *Consolidated Rock Products Co.* case, Mr. Justice Douglas pointed out that any claim might be settled provided the

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Commission recommending approval of the plan of reorganization for McKesson & Robbins, Inc., proposed by the trustee. In summarizing its findings, the Commission stated with respect to the treatment of creditors and stockholders as follows:

"(2) The treatment accorded to creditors is fair and equitable, on the assumption that there will be an underwriting of the securities issuable to them or that prior to confirmation there will be no appreciable change in market conditions which would adversely affect the value of such securities, to the extent that creditors could not realize the full value of their claims.

"(3) The plan gives adequate compensation to old preference stockholders for the value of their interest and the surrender of their priority in view of the estimated value of the securities given to them, and the fact that the plan accords to them a larger claim in the earnings of the company than they now possess and a high degree of control commensurate with their financial stake in the enterprise.

"(4) The plan is fair with respect to the common stockholders in that it accords them the residual equity and safeguards this position against possible future dilution."

The plan in the McKesson & Robbins, Inc. reorganization was confirmed by Judge Coxe on May 15, 1941. At the time of confirmation the testimony of an expert was introduced to show that the market value of the new securities has not changed since the court's approval of the plan. This action is in line with the statement in the Commission's Advisory Report that the Report was given on the assumption that in determining the probable market value of the new securities "there will be no appreciable change in market conditions" prior to confirmation of the plan which would adversely affect estimated values. Presumably the plan, now confirmed, would not be held to be unfair or inequitable merely because the actual market value of the new securities turned out to be different from the estimated market value.

Compare majority and minority opinions of S. E. C. Holding Company Act Release No. 2635, *Federal Water Service Corporation, Utility Operators, Federal Water & Gas Corporation*, dated March 24, 1941.

[64]"Close questions of interpretations of after-acquired property clauses in mortgages, preferences in stock certificates, divisional mortgages and the like will give rise to honest doubts as to which security holders have first claim to certain assets. Settlement of such conflicting claims to the *res* in the possession of the court is a normal part of the process of reorganization. In sanctioning such settlements the court is not bowing to nuisance claims; it is administering the proceedings in an economical and practical manner." 308 U. S. 106, 130, 60 Sup. Ct. 1 (1939).

settlement was "with the approval of the Court after full disclosure and notice to interested parties." He went on to state, however, that any "strategic or nuisance value outside of 77B does not detract from or impair the power and duty of the bankruptcy court to require a full accounting as a condition precedent to approval of any plan of reorganization."[65]

Furthermore, if a determination of solvency is necessary in all cases, certain practical difficulties will inevitably arise. Does it mean that in cases of doubt, where the stockholders are willing to litigate the question of solvency indefinitely, the Court may not in the exercise of its discretion grant the stockholders any participation in assets even when consented to by the requisite percentages of senior security holders? This would certainly seem to follow from the *Los Angeles Lumber Co.* and *Consolidated Rock Products Co.* cases,[66] although in the *Philadelphia & Reading Coal & Iron Co.* case[67] it had previously been held that there must be an express determination of solvency or insolvency in any reorganization.

Considering the Supreme Court's express qualifications as to what sort of settlements may be made and considering also the emphasis placed on the necessity for specific valuation of assets, it would seem that a broad, general settlement of many conflicting claims can no longer be made or at least not without fully valuing the claims and in effect litigating them in advance of final reorganization. Some of the important practical advantages of a settlement, such as avoiding the expense and delay of litigation, would seem more difficult to attain. But the courts, with their usual ingenuity, will probably find a way.

Even before the *Consolidated Rock Products Co.* decision, the Securities and Exchange Commission, in considering the meaning of a "fair and equitable" plan, had rejected the theory that security holders having an equity may "contract" as to their respective participations, if such contract resulted in giving something to the stockholders before the creditors were paid in full.

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[65] 61 Sup. Ct. at 683.

[66] Even before these cases were decided, Judge Holly, in In re *Utilities Power & Light Corporation, 29 F. Supp. 763, 770 (N. D. Ill. 1939),* stated, with respect to the application of the absolute priority rule:

"It is true that many courts, including this court (*In re Georgian Hotel Corporation,* 7 Cir., 82 F. 2d 917), have allowed insolvent debtors in reorganization proceedings to retain a small interest in the corporate assets. Rather than a 'relative priority approach' this has been a pragmatic approach. In each of these cases a very large majority of the creditors, in many of the cases nearly 100%, have consented to and urged the adoption of the plan. In most of them the debtor has given up something having at least a 'nuisance' value, and approval of the plan seemed on the whole, better for the creditors. But since *In re 620 Church Street Bldg. Corporation,* 299 U. S. 24, 57 S. Ct. 88, 81 L. Ed. 16, it would appear that an insolvent debtor may not be permitted to participate in the distribution of the assets in a reorganization proceeding over the objection of a single creditor."

[67] *In re* Philadelphia & Reading Coal & Iron Co., 105 F. (2d) 357 (C. C. A. 3d 1939).

In the Commission's Reorganization Release, *In the Matter of Flour Mills of America, Inc.*,[68] it was pointed out that if bargaining between creditors and stockholders was permitted, the "extent of the sacrifices or profit of the security holders would be dependent in a large degree on the trading ability of their representatives, subject to such standards as might be adopted out of respect for the chancellor's conscience."[69]

Since stockholders may not under any circumstances, where the corporation is insolvent, make contractual arrangements with the creditors against a single creditor's dissent, investors may well express a preference for bonds rather than stock. *Per contra,* it may well be argued that the strict application of the "absolute priority rule" may prevent investors from investing in thin equities. But if the assets of a company must be valued on the basis of the capitalization of reasonably prospective earnings rather than on the basis of original cost or reproduction cost or fair value of assets or any variety of other factors which may possibly give a more accurate picture in times of depression, obviously the position of a holder of equity securities of financially embarrassed corporations, in times of depression is precarious.[70]

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[68]S. E. C. Corporate Reorganization Release No. 22, dated April 11, 1940. See Judge Healy's dissent at pp. 29-35 in S. E. C. Holding Company Act Release No. 2635, *Federal Water Service Corporation, Utility Operators, Federal Water & Gas Corporation,* dated March 26, 1941, as to the meaning of "fair and equitable" in Section 11(e) of the Public Utility Act of 1935.

[69]The Commission also pointed out in this connection:

"Intimations to the effect that the 'contract' of security holders is a substitution for the full priority principle contained in *Downtown Investment Assoc. v. Boston Metropolitan Bldgs., Inc.,* 81 F. (2d) 314, were expressly revoked by the Supreme Court in the *Los Angeles* case." Corporate Reorganization Release No. 22, n. 70.

[70]It is interesting in this connection to review the various reports and statistical services relating to the United States Steel Corporation and other heavy industries in and around 1932, and to speculate as to what a valuation of the corporation's assets would have shown at that time if based on "reasonably prospective earnings." In view of the restricted capacity under which "big steel" was operating then and the pessimistic prospects for the future, it seems at least doubtful, if it then had senior security holders, and it had had to file under Section 77B, whether stockholders could have been given any participation in a reorganization plan. Since 1932, however, the situation has completely changed, due to factors which obviously could not have been predicted at the time. See remarks of Myron C. Taylor at annual meeting of stockholders of U. S. Steel Corporation on April 4, 1938, quoted by Jerome N. Frank, in "Too Much Interest in Interest," in speech made before National Association of Securities Commissioners, Kansas City, Missouri, September 22, 1938. Frank, *Save America First* (1938); and *Debts and Recovery,* Twentieth Century Fund; *cf.* 1 BONBRIGHT, VALUATION OF PROPERTY (1935) 238: "... the prospective earnings of a company play a role quite different from that played by other data adduced in proof of a value of the property. These other data, such as the original costs of the separate assets, or estimated replacement costs, or current market prices of outstanding security issues, have no significance whatever save as a clue to the earnings that may fairly be capitalized. The mere fact that the physical assets ... may actually have cost many million dollars to construct, not only fails to determine the present value of the company—it has utterly no influence on this value unless, in some indirect way, it may affect the net earnings. And precisely the same statement applies to established replacement costs of the physical assets, no less than to the historical costs. It will benefit the owner of an enterprise nothing to

It is true that stockholders in the past have at times resorted to dilatory or destructive tactics in holding up hondholders. It is argued they knew the terms of the contract when they purchased and should have stipulated for better treatment on reorganization. Yet it must be borne in mind that the early history of nearly all corporations, especially corporations in new fields, is fraught with periods of disaster and difficulty. Prospective earnings seem remote. As a complete wiping out of equities on such a basis seems unduly harsb inasmuch as governmental agencies are encouraging equity investments and even believe life insurance companies should invest in equities, it must be hoped that the courts will temper the "absolute priority" theory in justifiable situations, for if investors were to invest only in enterprises of established earning power, or in properly protected equities, Thurman Arnold would have cause to complain of far greater monopoly than exists today and society would be the loser.

One of the results of a strict application of the "absolute priority rule" may be to discourage management from investing additional equity capital in shaky situations. In fact, it should tend to induce the abandonment of border-line enterprises as soon as possible, where an additional equity investment is needed, so as to give any outside capital remaining to the equity security holders a chance for a fresh start in a new enterprise. Even express understandings or agreements with most of the creditors (for instance, to the effect tbat investment of additional capital will be taken into consideration by the creditors in

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possess a company with costly assets. What the owner wants is profitableness."

There is, of course, the possibility of a tremendous difference between a valuation based solely upon the appraisal of company property and one arrived at by capitalization of earnings. Even valuations based on reasonably prospective earnings may differ considerably depending upon particular appraisers' assumptions as to what rate of return a willing investor would accept. *Randall v. Bailey, 23 N. Y. S. (2d) 173 (Sup. Ct. 1940)* was an action by a trustee appointed in 77B proceedings to recover from the directors of a New York corporation for the declaration and payment of a dividend which allegedly resulted in an impairment of capital. The determination of whether such impairment had resulted from the payment in question was, of course, dependent upon what constituted "capital" and what constituted "surplus" at the time of payment. This in turn was dependent on what was the value of the corporation's assets at the time. Both the plaintiff trustee and the defendant directors presented the evidence of appraisers who, though using different methods, came to a similar figure for reproduction costs. When it came, however, to arrive at a valuation by the method of capitalizing earnings the views of the appraisers were sharply contrasted. The plaintiff's appraiser came to the conclusion that the earnings failed to support a figure equal to the liabilities to creditors and stockholders, whereas the defendant's appraisers thought that the earnings supported a value substantially equal to the reproduction cost. The plaintiff submitted also the valuation of a third appraiser based entirely on capitalization of earnings and reaching a valuation below even that of the plaintiff's first appraiser. The court felt that both of the plaintiff's appraisers had capitalized the net earnings at too high a rate and approved the valuation of the defendant's appraisers. The case illustrates the problem which faces a court in choosing from among varied estimates, based on similar data, that which most accurately reflects the true value of the business, taking into consideration all factors.

any reorganization) will be of small comfort to holders of equities as long as a single dissenting creditor can upset the agreement. Obviously, if there is any doubt as to whether there is an equity for stockholders, it is to their advantage to stave off reorganization as long as possible, since in such a situation the moment a reorganization plan is filed they may surrender whatever chances they have of preserving their equity.

The relative merits and demerits of the "Two Rival Theories of Priority Rights of Securityholders in a Corporate Reorganization" were ably set forth in 1928 by Professor James C. Bonbright and Milton M. Bergerman.[71] Both the legal and social advantages and disadvantages of the two theories were discussed, and it is interesting that in 1928 Professor Bonbright thought that the courts would not, at least permanently, revert to the old doctrine of absolute priority on the ground that it was not well adapted to the corporate form of organization and that its place might properly be taken by a modified form of the doctrine of relative position. It will be interesting to see what effect the reaffirmation of the absolute priority doctrine will have in the current programme of the Securities and Exchange Commission announced in the *El Paso* case[72] calling for a greater percentage of equity financing in public utility company capitalizations.

In the Congressional Reports and Hearings[73] on Section 77B and even in the earlier 77B reorganizations,[74] the prevailing view seemed to be that the purpose of the statute was primarily to relieve debtors—the emphasis being on giving hard-pressed corporations a chance to get back on their feet. However, with the present strict application of the "absolute priority rule," reorganizations under Chapter X are a long way from this original purpose.

IV. Public Utility Holding Companies

In connection with the "absolute priority rule" as now applied in court

[71]Bonbright and Bergerman, *Two Rival Theories of Priority Rights of Securityholders in a Corporate Reorganization* (1928) 28 Col. L. Rev. 127. See also Weiner, *Conflicting Functions of the Upset Price in Corporate Reorganizations* (1927) 27 Col. L. Rev. 132.

[72]In the Matter of Engineers Public Service Company, El Paso Electric Company, a Delaware corporation, El Paso Electric Company, a Texas corporation, Mesilla Valley Products Company, S. E. C. Holding Company Act Release No. 2535, dated February 5, 1941. Compare Dodd, *The Los Angeles Lumber Products Company Case and Its Implications* (1940) 53 Harv. L. Rev. 713, 723.

[73]See especially H. Rep. No. 194, 73d Cong., 1st Sess. (1934) of the Committee on the Judiciary.

[74]For instance, in the early stages of the Bush Terminal Company and Prudence-Bonds Corporation reorganizations, the Court made it clear that it felt creditors should "go easy" on the debtor and that no plan would be approved unless it achieved the legislative objective of rehabilitating the debtor. The reversal of attitude is indicated by the Supreme Court's decision in In re *620 Church St. Bldg. Corp., 299 U. S. 24, 57 Sup. Ct. 88 (1936). Cf.* Downtown Investment Assn. v. Boston Metropolitan Bldgs., 81 F. (2d) 314 (C. C. A. 1st 1936), in effect over-ruled by later decisions.

reorganizations it is interesting to compare the broad objectives expressed in certain sections of the Public Utility Holding Company Act of 1935.

Under Section 11 of the 1935 Act the Commission is charged with the duty of examining the corporate structure of every registered holding company and subsidiary company thereof, to determine the extent to which the corporate structure of such holding company system and the companies therein may be simplified, unnecessary complexities eliminated, voting power fairly and equitably distributed among the holders of securities thereof, and the properties and businesses confined to those necessary or appropriate to the operations of an integrated public utility system. As soon as practicable after January 1, 1938, the Commission is charged with the duty of requiring by order that each registered holding company, and each subsidiary company thereof, shall take such action as the Commission shall find necessary to limit the operations of the holding company system of which such company is a part to a single integrated public utility system, and to such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public utility system. The Commission has recently been issuing to registered public utility holding companies a series of orders requiring them to show cause why they should not be compelled to comply with the provisions of Section 11.

Under Section 7 of the 1935 Act, the Securities and Exchange Commission must grant its approval before certain securities of registered public utility holding companies and their subsidiaries may be issued. The Commission must find that the security to be issued is either a common stock having a par value and equal voting rights with other outstanding securities or is a bond secured by assets of a character approved by the Commission, with the exception that these limitations on the types of securities which can be issued do not apply if the issue is for the purpose of refunding an outstanding security or to effect a merger or reorganization, or to finance the business of the issuer as a public utility company, or is for necessary and urgent corporate purposes and the above limitations on character of securities would impose an unreasonable financial burden not necessary in the public interest. In addition to the foregoing, the Commission is directed to approve a security issue unless it finds that (1) the security is not reasonably adapted to the security structure of the company and the other companies in the same holding company system; or (2) the security is not reasonably adapted to the earning power of the issuer; or (3) the financing is not necessary or appropriate to the economical and efficient operation of the business of the issuer; or (4) the fees and commissions to be paid in connection with the issuance and sale of the security are not reasonable; or (5) the necessary state laws have not been complied with; or unless (6) if the transaction is between a registered holding company and a subsidiary thereof and any other company in the same holding company system, or any affiliate of any company in the same holding company system, there has been a "maintenance of competitive conditions."

In *Matter of Federal Water Service Corporation*,[75] the Securities and Exchange Commission, in its majority opinion, introduced a new note of "flexibility" into the "fixed principle" and "rigorous standard" of the *Boyd* case by limiting the application of the "fair and equitable" standard of Section 11(e) of the Holding Company Act, and consequently the necessity for allocating new securities in a reorganization in accordance with liquidating priorities and contractual rights as laid down by the United States Supreme Court in the *Boyd, Monon, Los Angeles Lumber Co.* and *Consolidated Rock Products Co.* cases to situations requiring liquidation of the corporation. The majority opinion held that where the standards of Section 11(b) of the Holding Company Act do not require liquidation of the enterprise, the "fair and equitable" standard of Section 11(e) does not require distribution of the securities to be issued on the basis of liquidating priorities to the exclusion of recognition of contractual rights in a going concern.

In the *Federal Water* case, a registered holding company, Federal Water Service Corporation, which was not insolvent in either the bankruptcy or equity sense and its subsidiary, Federal Water and Gas Corporation, sought to put through an adjustment by merger of its capital structure by filing a declaration under Section 7 of the Holding Company Act, rather than filing under Section 11. The standard of Section 7 (d) (6) and 7 (e) is not "detrimental to the public interest or the interest of investors" and the standard for plans under Section 11 (d) and (e) is "fair and equitable," as in the case of bankruptcy and equity reorganizations. Although the plan proposed to distribute approximately 5% of the new common stock to the old junior preferred, which had no present equity in assets, but for which the majority found there was some reasonable expectation of participation in future earnings, the majority opinion limited the "fair and equitable" standard of Section 11 (e) as above set forth.

Despite Justice Douglas' rebuke to the District Court in the *Consolidated Rock Products Co.* case that a finding of value based on capitalization of reasonably prospective earnings is a *sine qua non* to finding a plan "fair, equitable and feasible," the majority of the Commission said:

> "Because of the necessarily conjectural nature of our data, we cannot place a precise value upon the claims of the Class A stock ultimately to participate in earnings. But we are not here sitting as a judge or jury

[75] S. E. C. Holding Company Act Release No. 2635, dated March 24, 1941.

in awarding damages or fixing the amount of a claim for breach of contract or of a lease.

"If we were in such a position, the usual rules of judicial proof would clearly apply, and only earnings reasonably foreseeable in the future could be looked to in determining the amount of damages. But we think that for our present purpose it is sufficient to determine whether the Class A stock has some value, the exact amount of which we need not determine. To reach the conclusion that it has some value, it is enough for us to conclude, as we do, that the Class A has a reasonable expectation of receiving earnings at some future time, and that this expectation cannot be dismissed as negligible. Accordingly, we think that the Class A is entitled to participate in the reorganized or recapitalized enterprise, both under the 'fair and equitable' standard of Section 11 (e) and, because the existence of this valuable right gives the Class A something with which to bargain, under the test of 'detrimental to the interest of investors' in Sections 7 (d) (6) and 7 (e).

"This conclusion is in harmony with our decision in *Community Power and Light Co.*, 6 S. E. C. 182 and 201 (1939). We realize that there is at first glance an apparent inconsistency between our conclusion that we can pass upon the fairness of this plan without more precise determination of value and the Supreme Court's recent holding in *Consolidated Rock Products Co. v. duBois*, that the exercise of judgment upon a plan of reorganization requires a more accurate determination of value than a mere conclusion that the value of the assets exceeds the amount of the senior claims. This factor and the existence of Commissioner Healy's dissent impel us to express more fully our conception of the application of the 'fair and equitable' standard to cases coming to us under Section 11 (e) of the Public Utility Holding Company Act.

"As an introduction we state our understanding of the 'fair and equitable' standard in equity receivership and bankruptcy reorganizations, under the rules laid down by the Supreme Court. Fundamentally, we believe, in common with the view expressed by Commissioner Healy in his dissent and by counsel for Federal in their brief, that this standard requires the full recognition of contractural rights. In equity receivership cases the standard came to have a 'fixed meaning', and the words 'fair and equitable' came to be 'words of art'. *Case v. Los Angeles Lumber Products Co., Ltd.*, 308 U. S. 106. The Supreme Court has held that the words had the same fixed meaning as applied to Section 77B of the Bankruptcy Act (*Case v. Los Angeles Lumber Products Co., Ltd., supra*), and has indicated that this is also true of the present Chapter X, which replaced Section 77B (*Securities and Exchange Commission v. United States Realty and Improvement Co.*, 310 U. S. 434, 452). This meaning is the following: No class of stockholders can participate unless all classes of creditors are compensated in full. As between classes of stockholders, a junior class may not participate until senior classes have been fully compensated for their liquidation preferences."

In a vigorous dissent Judge Healy after reviewing the *Monon, Boyd, Los*

Angeles and *Consolidated Rock Products* case, insisted that the words of art "fair and equitable" in Section 11 (e) had the same meaning in proceedings under the Holding Company Act as in bankruptcy proceedings, that the doctrine "fair and equitable" applied as between classes of stockholders and criticized the majority for holding that where liquidation is not imminent, the liquidation priorities have not "matured" and that therefore the rights which are entitled to "fair and equitable" treatment were not present in the *Federal Water* case.

Judge Healy held that since reorganization under Section 11 (b) (2) of the Holding Company Act was inevitable, reorganization was legally compulsory—and that this was the controlling factor. He pointed out that " . . . the compulsion of Section 11 (b) (2) is of greater force than a proceeding under Chapter X since under Section 11 (b) (2), unlike under Chapter X, the government can compel a reorganization."

He disagreed further with the majority that the basis for the "fixed principle" of the *Boyd* case was the imminence or "atmosphere" of liquidation and held that the "strict priority" doctrine announced in the *Boyd* case and reaffirmed in subsequent cases is founded upon a proper regard for the solemnity of contracts. Judge Healy dismissed as untenable the argument that the strict priority theory could be disregarded merely because the preferred stock could not force dissolution and was therefore not immediately entitled to its rights of priority.

If equity receivership and reorganization standards are to be applied to Section 11 (b) (2) proceedings under the Holding Company Act, which will be startling to holders of utility equities who have thought the standards of voluntary recapitalizations would apply, then Judge Healy's views would seem to be more in line with a literal reading of the *Monon, Boyd, Los Angeles Lumber Co.* and *Consolidated Rock Products Co.* cases. It will be interesting to see whether the Supreme Court agrees with the majority opinion that it is enough for the Commission to conclude that a security has a reasonable expectation of receiving earnings at some future time without making a determination that the security has some value. The distinction made by the majority between the necessity or non-necessity of liquidation is an ingenious one. While there was a readjustment of securities in equity receiverships, it does not seem realistic to state that there was always the imminence or "atmosphere" of liquidation. It was for the very purpose of preventing liquidation that equity receivership proceedings were invented and in the beginning at least both Section 77 and Section 77B were designed to permit temporarily embarrassed debtors to work out their salvation under the protection of the "Chancellor's umbrella."

Those interested in the reorganization of registered holding companies or their subsidiaries should note that Rule U-11F-1, promulgated by the Securities and Exchange Commission under the Public Utility Holding Company Act of 1935, requires that any person proposing to submit to a court of the United States a reorganization plan for a registered holding company or any subsidiary company thereof shall, prior to submission of such plan to the court, file with the Commission an application for the approval of such plan.[76]

V. Voluntary Recapitalization

The subject of voluntary recapitalization is beyond the scope of this paper, being the subject of a complete paper itself. A few comments may be interesting. Section 14 of the Securities Exchange Act of 1934 and Regulation X-14 of the Securities and Exchange Commission have done much to insure stockholders more complete and accurate information in the case of voluntary recapitalization of corporations whose securities are listed and registered on a national securities exchange. The Securities Act of 1933 is an assurance to investors that they should receive truthful information in the sale of new securities.

The strict standard of the equity and bankruptcy reorganization courts of "fair and equitable" is not applicable in voluntary recapitalizations. The laws of most of the states, under which corporations are organized, provide various machinery, including appraisal provisions, by which the rights of the stockholders may be adjusted; the various corporate charters contain explicit provisions in this regard and rights other than "vested" rights may be adjusted by the percentage vote appropriate to the particular change, as set forth in the statute or in the particular certificate of incorporation. A court of equity usually will not grant relief unless it can be proved that the plan is unfair to certain classes of security holders on the ground that there has been fraud or collusion, overreaching on the part of majority shareholders, violation of statute or charter provisions or violation of vested rights. Of course, such voluntary plans must be "fair and equitable," but it must be emphasized

[76]Compare Section 177 of the Bankruptcy Act, requiring that in the case of a public utility corporation, a plan of reorganization shall not be approved unless first submitted to any commission having regulatory jurisdiction over the debtor, such commission to be afforded an opportunity to suggest amendments or offer objections, which must be considered by the judge at a hearing at which the commission may be heard. See also Section 178, as to the requirement of obtaining the prior approval of state public service commissions, in the case of wholly intra-state public utility corporations. See the very interesting address of Commissioner Robert E. Healy of the Securities and Exchange Commission, before the Section of Public Utility Law at the Convention of the American Bar Association, September 10, 1940; and the address of Joseph L. Weiner, Director of the Public Utility Division of the Securities and Exchange Commission, before the Practicing Law Institute, New York City, October 14, 1940.

that the standard is not strictly speaking the standard we have just discussed, a wide variety of other factors being considered.

From the standpoint of what is "fair and equitable" in voluntary recapitalizations, some of the recent leading cases in the field may be mentioned briefly.

In *Breslav v. New York and Queens Electric Light and Power Co.,*[77] the court was called upon to consider the validity of the defendant corporation's action in calling a meeting of stockholders to vote upon an amendment of the corporate charter which would make non-callable preferred stock redeemable at a price above par. The purpose of the corporation's action was to call in enough of the preferred stock to give a parent corporation 95% ownership, in order that it might under the New York statutes effect a merger. The court, at the instance of a preferred stockholder, enjoined the intended action, saying *first* that Section 36 (E) of the Stock Corporation Law authorizing a reclassification of shares did not authorize making non-callable stock callable by a vote of two-thirds of the outstanding shares, and *second* that if the New York statutes did intend to authorize this action they would be unconstitutional as violative of the contract clause of the Federal Constitution since the result of their application would be the divesting of a vested interest in the corporation without due process of law and would not be a proper exercise of the reserved power to repeal or change a corporation's charter. In the supplementary case of *Breslav v. New York and Queens Electric Light and Power Co.,*[78] the Court of Appeals held that a complaint setting forth the purposes and the intended result of the corporate action as outlined above stated a cause of action.

In *Albrecht, McGuire & Co. v. General Plastics, Inc.,*[79] the corporation proposed by filing a certificate under Section 36 of the Stock Corporation Law to abolish preemptive rights to a new issue of stock. Out of a total of 116,000 shares outstanding, 112,000 voted for the amendment. A dissenting stockholder brought an action to have the certificate of reclassification declared null and void as an invalid deprivation of his right to a proportionate share of the new stock. The Appellate Division held that Section 36 no more authorized the destruction of preemptive rights than it gave warrant to the destruction of the right of non-callability, and held the certificate of reclassification void so far as it related to the dissenter who brought the action. The corporation was directed to offer the dissenter an opportunity to subscribe before otherwise selling or offering the stock.

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[77]249 App. Div. 181, 291 N. Y. Supp. 932 (2d Dep't 1936).

[78]273 N. Y. 593, 7 N. E. (2d) 708 (1937). See Note (1935) 83 U. OF PA. L. REV. 888.

[79]256 App. Div. 134, 9 N. Y. S. (2d) 415 (4th Dep't 1939); see c. 691 of the Laws of 1941 of the State of New York adding a Section 39 to the Stock Corporation Law in relation to preemptive rights.

The significance of these cases lies in the fact that the reorganization court would be called upon to consider the rights there affirmed in deciding whether a plan of reorganization is "fair and equitable." This, of course, will not be because the reorganization must not impair the obligation of contracts since of course the contract clause in the Fourteenth Amendment is not strictly a limitation on federal power (certainly it is not a restriction on the bankruptcy power), but because non-callability has been called a vested right. If it be such a particular situation, it would probably have to be considered of some value and compensation rendered therefor in a reorganization that is "fair and equitable."

In *Keller v. Wilson*,[80] Wilson & Co., Inc., wished to put through a plan of recapitalization by which it was proposed to exchange old cumulative preferred stock for a new issue of cumulative preferred stock without providing for the payment of dividends which had accrued on the old stock. A stockholder filed a bill to declare null and void the amendment to the charter which had been filed and the shares which had been issued to stockholders. Section 26 of the Delaware Corporation Law permitted the reclassifying of shares by charter amendment, but the charter in question had been filed and the shares in question issued before the enactment of Section 26. The court held that Section 26 did not authorize a wiping out of accumulated dividends and said, as did the New York Court of Appeals in the *Breslav* case, that if it did so intend, it would be unconstitutional as violative of due process. The court did not purport to decide that if the stock had been issued subsequent to the passage of Section 26 the dividends could not be wiped out. It merely said that the statute was not intended to operate retroactively.

However, in *Consolidated Film Industries v. Johnson*,[81] corporate action similar to that of the *Keller* case, but with regard to shares issued subsequent to Section 26, was under consideration. The court again held for the stockholder, saying that Section 26 gave the corporation the power to amend the charter for the purpose of wiping out the right to cumulative dividends in the future but did not grant the power to destroy such dividends accumulated prior to the proposed amendment. The court failed to see a difference in principle between this case and the *Keller* case. The *Johnson* case presented the additional factor of a charter provision reserving to the corporation the right to alter the provisions of the certificate of incorporation. The court hurdled this problem by saying that the language of the charter provision was no broader than that of Section 26 and hence had no greater effect.

[80] 190 Atl. 115 (Del. 1936), (1936) 36 Col. L. Rev. 674. See Note (1935) 10 Temp. L. Q. 86.

[81] 197 Atl. 489 (Del. 1937).

The third Delaware case dealing with this general subject is *Federal United Corporation v. Havender.*[82] In this case again the stockholder was entitled to receive, when declared, accumulated dividends on the preferred stock held by him. Here, however, the corporation effected a merger with a wholly owned subsidiary and in pursuance of such merger undertook to convert the stockholder's preferred stock into other securities designed to compensate him for the accumulated dividends, without specifically paying in money dividends accrued thereon. The merger was effected under Section 59 of the Delaware General Corporation Law, which provided for the appraisal of dissenting stockholders' rights. The court construed Section 59 as permitting corporations, pursuant to a merger, to provide for accumulated dividends by means other than the payment of cash. The court stated that where tbe plan is "fair and equitable" a dissenting shareholder given consideration for his unpaid dividends has not been deprived of any vested right by being denied the power to veto the merger. The court on motion for reargument further held that the merger section of the Corporation Law was intended to have retroactive operation and hence authorized the changing of rights with regard to accumulated dividends.

The result of these Delaware cases is substantially that what cannot be done by a charter amendment can be done by a "fair and equitable" merger. It is certain that the *Havender* case does not change the rule of *Keller v. Wilson.* Accumulated dividends in certain other jurisdictions are considered to be a vested right but the authorities are by no means uniform and in several jurisdictions there is a tendency to break away from the vested rights theory.[83] In some jurisdictions the right to adjust depends on whether there were

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[82] 11 A. (2d) 331 (Del. 1940); see also Clarke v. Gold Dust Corp., 106 F. (2d) 598 (C. C. A. 3d 1939).

[83] 12 FLETCHER, CYCLOPEDIA CORPORATIONS (1932) 193, and cases there cited. For a clear statement of the nature of this right, see Roberts v. Roberts-Wicks Co., 184 N. Y. 257, 77 N. E. 13 (1906). See also S. E. C. Holding Company Act Releases Nos. 641, 642, 770, 850 and the Annual Report of the S. E. C. to Congress, dated May 19, 1938, pages 160, 172. The rule as to the inviolability of accumulated dividends was recently reaffirmed in New York in the case of *Wiedersum v. Atlantic Cement Products, Inc., 261 App. Div. 305, 25 N. Y. S. (2d) 496 (2d Dep't 1941)*; for an excellent review of the authorities, see Note, *Elimination of Accrued Dividends and Corporate Reconstruction* (1941) 89 U. OF PA. L. REV. 789; Lattin, *Remedies of Dissenting Stockholders Under Appraisal Statutes* (1931) 45 HARV. L. REV. 233. In *Patterson v. Henrietta Mills, 216 N. C. 728, 6 S. E. (2d) 531 (1940),* it was held that a voluntary plan of reorganiation which wiped out accumulated dividends was void as to a dissenting stockholder. In the supplementary case of *Clark v. Henrietta Mills, 12 S. E. (2d) 684 (N. C. 1941)* it was held that a non-assenting stockholder is not barred although he did not protest in stockholders' meetings but informed the officers of his non-acquiescence. See *Sander v. Janssen Dairy Corp., 14 The Corporation Journal 344 (D. N. J. 1940)* for intimation that accumulated dividends might be wiped out under Section 27 of the General Corporation Act of New Jersey. Two states (Ohio and Virginia) have legalized the wiping out of accrued dividends. OHIO CODE ANN. (Throckmorton's Baldwin, 1940) §§ 8623-14, 15; VA. CODE ANN. (Cum. Supp.) § 3780. See Note (1941) 89 U. OF PA. L. REV. 789, 791.

earnings in the years the dividends accumulated and in others it is specifically granted by statute. It does not follow, however, that this right, like any other, cannot be cut down to some extent by a "fair and equitable" reorganization under a federal statute. Indeed, in In re *Community Power & Light Co.*,[84] the court approved, pursuant to Section 11(e) of the Holding Company Act for a Delaware corporation, a plan which resulted in the compounding of accumulated dividends, the court saying, "The plan before this court is not based on Delaware law, but on paramount Federal law which is not subject to Section 10 of Article 1 of the Federal Constitution." This statement is, of course, directed to the argument in the *Keller* case that the elimination of accumulated dividends would be violative of contract obligations. As the contract clause is not a limitation on federal power, and as plan under Chapter X in order to be confirmed must be fair and equitable (thus eliminating any argument on the grounds of due process), the Delaware cases cannot be deemed to constitute a restriction on the powers of a federal equity court in passing on plans of reorganization under Chapter X, except in connection with the determination of what is "fair and equitable."

A case which is of primary importance is *Johnson v. Fuller*,[85] in which case the capital structure of the defendant Curtis Publishing Company consisted of 9,000,000 shares of preferred stock with cumulative dividends of $7 per share and 1,800,000 shares of common stock. The established dividends on the preferred stock could not be paid and accumulations mounted to $16.87 per share. A plan of reorganization was accepted by 72% of the stockholders providing for the surrender and cancellation of the existing preferred shares (including the accrued dividends) in exchange for a $10 share in a debenture, one share of prior preferred stock carrying fixed cumulative dividends of $3 and two and one-half shares of common stock for each share of the old preferred stock held. In the event that the preferred stockholders did not wish to exchange, the plan provided that they should retain their shares with the right to receive dividends at the existing rate, as well as the accumulated dividends, subordinated however, to the $10 debenture and to the dividends on the new preferred stock, but payable before any dividend on the common stock. The question presented to the court was whether this plan was so harsh in the choice presented to the stockholders that it violated a contract in the charter to the effect that the company would not, while any of the preferred stock remained outstanding, without the consent of the holders of two-thirds of such stock, create any obligation entitled to priority in payment to the dividends on the preferred stock. The court reviewed the rulings in the Delaware courts

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[84]33 F. Supp. 901 (S. D. N. Y. 1940).
[85](D. C. Pa.) P-H Corporation Service, ¶ 21,145.

and said that they only held that cumulative dividends could not be eliminated without the consent of the holders so as to permit payment of dividends on the common stock before such cumulative dividends already accrued were paid. The court referred to the topheavy structure of the company and concluded that the proposed plan would work to the benefit of the preferred stockholders since it was a reasonable means of substantially improving the capital structure of the company. This was not in a Chapter X proceeding, but in a voluntary recapitalization under the laws of Pennsylvania. But the case is significant as showing that even where there is an express contract against later subordination, such subordination will be permitted if not too drastic and made on reasonable conditions.

As has already been mentioned, Section 36 (E) of the Stock Corporation Law of New York permits the reclassification of shares in a stock corporation. Section 38 (9) of the Stock Corporation Law, however, gives the holder of shares who does not vote in favor of the reclassification the right to an appraisal and payment if the certificate "alters preferential rights." In *Matter of Dresser*[86] the Court of Appeals held on legal rather than economic reasoning that the creation of a prior class of preferred stock did not alter the preferences of outstanding classes because the rights of the latter, *inter sese,* were not affected by the creation of the new class and that the changes did not give effect to a right of appraisal. However, in *Matter of Kinney,*[87] the Court of Appeals limited the rule of the *Dresser* case in a very interesting manner. In the *Kinney* case it was again proposed to create a new class of prior shares and in addition to reduce substantially the capital of the junior class of stock of the corporation by transferring a large sum to surplus, thus providing a fund against which losses could be charged and thus in effect permitting the resumption of the payment of dividends on the common stock. A dissenting shareholder demanded appraisal and payment on the grounds that the preferences of his stock had been changed. The court noted the *Dresser* case but distinguished it, holding that though the creation of the new prior class did not alter preferences, the reduction of capital with respect to a junior stock did, since the "cushion" which was security for the dissenter's shares had in the court's opinion been eroded.

VI. Chapter XI and the *United States Realty Co.* Case

Before relief can be obtained under Chapter X of the Bankruptcy Act, the applicant must advise the court that it is in no position to effect a com-

[86]247 N. Y. 553, 161 N. E. 179 (1928).
[87]279 N. Y. 423, 18 N. E. (2d) 645 (1939). For an excellent discussion of the protection of preferred stockholders see dissenting opinion of Commissioner Frank in S. E. C. Holding Company Act. Release No. 1427, *In the Matter of The North American Company,* dated January 20, 1939.

position under Chapter XI. Chapter XI, in effect, provides for an arrangement modifying unsecured debt and is not available to corporations with secured debt. The proposed plan must be consented to by at least a majority in number and amount of creditors affected. It is expressly provided that assents to the plan may be secured either before or after court approval of the plan. No provision is made for advisory reports on the plan by the Securities and Exchange Commission and the Commission is given no statutory right to intervene in the proceedings.

In *Securities and Exchange Commission v. United States Realty & Improvement Co.*,[88] the debtor corporation, the owner and manager of certain real estate investments, had outstanding 900,000 shares of stock in the hands of about 7,000 stockholders. Substantial issues of debentures were also outstanding and, in addition, the debtor was liable as a guarantor on a subsidiary company's mortgage certificates. The debtor proposed an arrangement with the holders of these mortgage certificates, involving primarily an extension of time for the payment of such certificates and a reduction in the interest rate. A majority of consents having been obtained, the debtor then filed a petition under Chapter XI praying that the arrangement be approved. The Securities and Exchange Commission intervened and moved that the order approving the debtor's petition be vacated and that the proceedings under Chapter XI be dismissed. The District Court granted the intervention but denied the Commission's motion. On appeal, the Circuit Court of Appeals reversed the order approving the Commission's intervention and dismissed its appeal.

In the Supreme Court's decision, reversing the Circuit Court of Appeals, Mr. Justice Stone in effect read the *Monon* and *Boyd* cases into Chapter XI and held that the plan must be "fair, equitable and feasible," that Chapter XI plans will not be considered fair and feasible where, because of large public holdings of the securities, a better procedure would be afforded by Chapter X, and that since in this case the stockholders' rights could not be readjusted under Chapter XI, the procedure of Chapter X would seem to be necessary for the working out of a "fair and equitable" plan.

The Supreme Court reiterated that a bankruptcy court is a court of equity and hence can determine whether relief under Chapter X is adequate before granting the relief requested under Chapter XI. The Court further held that the Securities and Exchange Commission's interest as a "safeguarder" of proceedings under Chapter X was sufficient to make its intervention (in order to prevent the avoiding of Chapter X) "a claim or defense under Rule 24 of the Rules of Civil Procedure." In other words, under this holding, the Commission becomes a statutory watchdog to protest alleged improper use of

88 310 U. S. 434, 60 Sup. Ct. 1044 (1940).

Chapter XI even though by the statute it was given the right to intervene in Chapter X proceedings and not in Chapter XI proceedings.

It may be noted that in the *Los Angeles Lumber Co.* case, Mr. Justice Douglas pointed out[89] that "the 'fair and equitable' standard employed in § 77B was not then present in § 12" (the former composition section of the Bankruptcy Act and the historical antecedent of Chapter XI). However, in the *United States Realty Co.* case, the Court applied the "fair and equitable" doctrine of the *Boyd* case as a jurisdictional test of whether or not proceedings could be brought under Chapter XI. In effect, Mr. Justice Stone stated that no plan or "arrangement" which alters part of the capital structure of a corporation with securities outstanding in the hands of the public can be said to be "fair and equitable" within the meaning of the *Boyd* doctrine if it is to be effected under Chapter XI. Thus, in the case of such a corporation, whether a plan is "fair and equitable" can be determined not in Chapter XI, but only in a Chapter X proceeding with the expert advice of the Securities and Exchange Commission and with resort to the facilities provided by Chapter X for investigation of the financial position and structure of the debtor.

While Section 146(2) of Chapter X provides that one of the conditions precedent for relief under Chapter X is that adequate relief would not be obtainable under Chapter XI, there is nothing in the Act to support the contention of the Supreme Court that inadequacy of relief under Chapter X should be considered as a condition precedent for relief under Chapter XI. Certainly it is stretching the powers of a court of equity rather far to refuse relief to a debtor who meets the literal requirements of an act of Congress. Whatever the court's personal views of the fairness of the plan may be, it would seem preferable to permit any defects in a statute to be corrected by legislative processes rather than to substitute judicial legislation on the question.

Furthermore, it seems doubtful that the Court really meant all of the language in the *United States Realty Co.* case to be taken literally. Does the decision mean, for example, that a corporation with securities held by the public cannot even obtain a breathing spell in Chapter XI for its trade debts? Probably not; yet this is what the opinion might lead one to believe. To what extent must the securities be publicly distributed? Will "trade debts" be distinguished from "funded debt" or bank loans? Amendments to Chapter XI to provide additional criteria in this connection are already being considered.

VII. Recent Cases on Allowances

In *Dickinson Industrial Site, Inc. v. Cowan,*[90] the United States Supreme

[89]308 U. S. 106, 120, n. 14, 60 Sup. Ct. 1 (1939).
[90]309 U. S. 382, 60 Sup. Ct. 595 (1940).

Court held that appeals from all orders granting or refusing to grant allowances of compensation or reimbursement under Chapter X may be had only at the discretion of the Circuit Court of Appeals. Previously, the Circuit Court of Appeals for the Second Circuit had held in *London v. O'Dougherty*[91] that appeals from such orders (involving $500 or more) could be had as a matter of right. In fact, the Circuit Court of Appeals had at times reprimanded attorneys for the over-cautious practice of filing petitions for leave to appeal with it as well as filing notices of appeal with the District Court.

In the reorganization of Prudence-Bonds Corporation under old Section 77B of the Bankruptcy Act, the special master and the District Court had awarded allowances aggregating over a million dollars. The reorganized company and Reconstruction Finance Corporation appealed, contending that the amount should be drastically reduced, and some of the claimants also appealed, asking for increases. In all these appeals, petitions for leave to appeal were not filed with the Circuit Court of Appeals for the Second Circuit, in express reliance on the above mentioned decision of such Court in *London v. O'Dougherty*. After briefs had been filed and oral argument heard, and while the appeals were still pending undetermined, the United States Supreme Court decided the *Dickinson* case referred to above, in effect reversing the Second Circuit Court of Appeals' established practice on the matter. Thereupon certain of the respondents moved for a dismissal of the appeals as to their allowances, on the ground of lack of jurisdiction, which motion the Circuit Court of Appeals granted, and at the same time dismissed all the other appeals *sua sponte*.

On appeal to the United States Supreme Court, in *Reconstruction Finance Corporation*, et al. *v. Prudence Securities Advisory Group*, et al.,[92] it was held that the failure to file a petition for leave to appeal with the Circuit Court of Appeals (as required by Section 25 of the Bankruptcy Act, pursuant to the decision in the *Dickinson* case) was not a *jurisdictional* defect in the sense that it deprived the Circuit Court of Appeals of the power to allow the appeals. The Supreme Court, apparently motivated largely by a desire to do "substantial justice" in the particular circumstances, stated (through Mr. Justice Douglas):

> "The court has discretion, where the scope of review is not affected, to disregard such an irregularity in the interests of substantial justice. . . . In this case the effect of the procedural irregularity was not substantial. The scope of review was not altered. There was no question of the good

[91] 102 F. (2d) 524 (C. C. A. 2d 1939).

[92] 61 Sup. Ct. 331, 85 L. ed. 300 (1941). The sequel to this decision is also interesting. When it was learned that the Circuit Court of Appeals could pass on the merits of the pending appeals, a number of the parties negotiated settlements of their allowances, most of which settlements provided for reductions of around 20% to 25%.

faith of petitioners, of dilatory tactics, or of frivolous appeals. Hence it would be extremely harsh to hold that petitioners were deprived of their right to have the court exercise its discretion on the allowance of their appeals by reason of their erroneous reliance upon the permanency of *London v. O'Dougherty, supra.*"[93]

Mr. Justice Reed, in his concurring opinion, Mr. Justice Roberts joining him, felt that the decision should be placed squarely on the unique circumstances of the case. He stated that "in rare instances such as the case at bar," the court is justified even in curing jurisdictional defects by the exercise of its "broad power to make such disposition of the case as justice requires."

In In re *Detroit International Bridge Co.*,[94] the court did not follow the recommendations of counsel for the Securities and Exchange Commission as to the amounts of the allowances to be granted, stating that such recommendations, though entitled to be made, were not conclusive since the court itself must determine the fair value of the services rendered. The court pointed out in this connection that where the compensation of an attorney is to be fixed by the court in reorganization proceedings, the attorney is entitled to the fair and reasonable value of the services rendered and among the circumstances to be considered are (1) the extent and nature of the services, labor, time and trouble involved, (2) the results achieved, (3) the character and importance of the matter at hand, (4) the value of the property or amount of money involved, (5) the learning, skill and experience exercised, (6) whether the payment of the fee was to be absolute or contingent and (7) the ability of the debtor to pay such fee.

In In re *Keystone Driller Company*,[95] the court, in considering a contention that the cash position of the debtor did not permit it to pay the allowances granted, modified the decree on allowances by reducing the amounts to be paid in cash by 15% and substituting therefor new preferred stock to be delivered to the claimants at the same special rate as offered to stockholders.[96]

In *Woods v. City Nat. Bank of Chicago*,[97] the claimants for the allowances in question were an indenture trustee, a bondholders' committee and the committee's counsel, who were also counsel for the indenture trustee. The committee of five members was formed by the indenture trustee, two of the committee's most active members being officers of the indenture trustee. Two of the other members were officers or employees of one of the principal

[93]61 Sup. Ct. at 333.
[94]111 F. (2d) 235 (C. C. A. 6th 1940).
[95]32 F. Supp. 949 (W. D. Pa. 1940).
[96]Compare Security-First Nat. Bank of Los Angeles v. Bank of America Nat. Trust & Savings Assn., 111 F. (2d) 50 (C. C. A. 9th 1940), where the court directed payment of attorneys' fees from certain oil lease proceeds.
[97]61 Sup. Ct. 493, 85 L. ed. 478 (1941).

underwriters of the bonds. This underwriter was "heavily interested in the equity," a fact which had not been disclosed when the committee solicited the bondholders. The property being reorganized was an apartment hotel. The neighboring apartment properties were also being reorganized at the same time, the indenture trustee (and its same counsel) being involved in several of these similar reorganizations.

On a counter-claim by the bankruptcy trustee against the indenture trustee for alleged misconduct and negligence, the Circuit Court of Appeals for the Seventh Circuit had held that there was no conspiracy to defraud nor any substantial evidence of mismanagement or negligence on the part of the indenture trustee.

Although accepting the Circuit Court of Appeal's finding that "fraud or unfairness" had not been shown to have resulted, the Supreme Court held that nevertheless where claimants had been "serving dual or conflicting interests" the District Court had the power (presumably in its discretion) to disallow any compensation whatsoever for services rendered. Some of the dicta of Mr. Justice Douglas went even farther, indicating that in such a case the District Court was *required* to deny the allowance:

> "Where a claimant, who represented members of the investing public, was serving more than one master or was subject to conflicting interests, he should be denied compensation. It is no answer to say that fraud or unfairness were not shown to have resulted."[98]

The Supreme Court pointed out that under Chapter X of the Bankruptcy Act the Court "has plenary power to review all fees and expenses in connection with the reorganization from whatever source they may be payable," that reasonable compensation for services may be allowed but the burden of proving their worth is on the claimant, and that "'the reasonable compensation for services rendered' necessarily implies loyal and disinterested service in the interests of those for whom the claimant purported to act."[99]

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[98]Mr. Justice Douglas further stated in this connection:

"Furthermore, the incidence of a particular conflict of interest can seldom be measured with any degree of certainty. The bankruptcy court need not speculate as to whether the result of the conflict was to delay action where speed was essential, to close the record of past transactions where publicity and investigation were needed, to compromise claims by inattention where vigilant assertion was necessary, or otherwise to dilute the undivided loyalty owed to those whom the claimant purported to represent. Where an actual conflict of interest exists, no more need be shown in this type of case to support a denial of compensation." 61 Sup. Ct. at 497.

[99]As to the relationship between the indenture trustee and the bondholders committee, Mr. Justice Douglas stated:

"The indenture trustee represents all the bondholders; the committee those who have given it authorizations—in this case about 50 per cent. Where the interests of majorities and minorities do not coincide, the interests of the indenture trustee and the committee will tend to be antagonistic. Beyond that is the fact that an indenture trustee closely affiliated with a committee shares the committee's conflicts of interest." 61 Sup. Ct. at 496.

However, the Court drew a distinction between claims for compensation for services and claims for reimbursement of expenses, holding that "reimbursement for 'proper costs and expenses incurred in connection with the administration' of the estate may be allowed."[100]

VII. Railroad Reorganizations

It is not possible in this paper to discuss in any detail the provisions of Section 77 of the Bankruptcy Act. Some of the problems affecting pending railroad reorganizations may be briefly mentioned.[101]

The outstanding characteristic of Section 77 proceedings is the part played by the Interstate Commerce Commission. Under the language of the statute, it would seem that, in determining the fairness of a reorganization plan, both the Commission and the federal district courts have original jurisdiction. In practice, questions of law, such as the validity of claims, priority of liens, etc., are determined solely by the courts, but as to the provisions of the plan, both the Commission and the courts must assume full responsibility, with the Commission taking the initial and leading role. The Commission is also required in the first instance to fix the maximum limits of the allowances for compensation and expenses, the final amounts within such limits being determined by the courts. Usually, however, the courts merely adopt the maximum allowed by the Commission.

Generally, the reorganization procedure is along the following lines: Extended hearings on the plan or plans proposed[102] are held before a commissioner and two examiners. Briefs are filed by the interested parties and thereafter one of the examiners submits a report recommending a plan (which plan may be entirely different from any of the plans proposed). After exceptions and briefs have been filed and oral argument heard before the Commission, the Commission hands down a report and order approving a plan, which in turn may be different from the examiner's plan. Within sixty days thereafter petitions for modification may be filed with the Commission and in special situations the hearings may be reopened or further oral argument

[100]The Court went on to state as to proper expenses:

"Plainly expenditures are not 'proper' within the meaning of the Act where the claimant cannot show that they were made in furtherance of a project exclusively devoted to the interests of those whom the claimant purported to represent." 61 Sup. Ct. at 497.

[101]For a full discussion of the subject, see *Railroad Reorganizations, a Symposium* (1940) 7 Law Contemporary Problems 365-542; and see also the excellent article by Robert T. Swaine, *Present Status of Railroad Reorganizations and Legislation Affecting Them* (1941) 18 N. Y. U. L. Q. Rev. 161.

[102]Under Section 77(d) the debtor is required to file a plan within six months after the entry of the order approving the petition, the judge being permitted to grant extensions from time to time, for cause shown, of not more than six months each. Plans may also be filed by the trustee or by creditors (10% in amount of any class) or stockholders (10% of any class) or with the consent of the Commission by any party in interest.

granted. The plan as finally approved by the Commission is certified to the court. Additional hearings are then held before the court, after which the court approves the Commission's plan (or, if the plan is not approved, dismisses the proceedings or refers the proceedings back to the Commission for further action). Finally, the plan is confirmed by the court after the requisite acceptances of creditors (and stockholders, if the debtor is not insolvent) have been obtained, with special provisions permitting confirmation of the plan even though such acceptances have not been obtained.[103]

The basic theory of Section 77, of course, is to take full advantage of the wide administrative experience of the Commission in railroad matters affecting the public interest. However, a great deal of confusion has resulted from the duality of jurisdiction granted to the Commission and the courts, primarily because Section 77 does not adequately distinguish between questions affecting the public interest and questions affecting private rights of the security holders.[104] Moreover, the cumbersomeness and duplication in the procedure (the "shuttling back and forth between the Commission and the courts"), as well as the inherent difficulties in railroad reorganizations, have inevitably caused long delays in practically all the proceedings."[105]

The time schedule in the Akron, Canton & Youngstown Railway Company reorganization, a relatively small road with relatively simple problems, affords a good example of the long drawn out procedure:

April 3, 1933	—Petitions for reorganization filed.
November, 1936	—Separate plans filed by the two Debtors and the Trustees (the intervening period being required to permit the railroad to build up working capital, the time also being used by interested parties to attempt to work out a satisfactory single plan).
January, 1937	—Hearings held before the examiners.
September, 1937	—Examiner's proposed report filed (in which the plans were rewritten, undoing much of the earlier work and making it difficult for the creditors to maintain a common front).

[103]Section 77(e) provides in this connection as follows:

" . . . If the plan has not been so accepted by the creditors and stockholders, the judge may nevertheless confirm the plan if he is satisfied and finds, after hearing, that it makes adequate provision for fair and equitable treatment for the interests or claims of those rejecting it; that such rejection is not reasonably justified in the light of the respective rights and interests of those rejecting it and all the relevant facts; and that the plan conforms to the requirements of clauses (1) to (3), inclusive, of the first paragraph of this subsection (e)."

[104]See discussion of this "primary defect" in Swaine, *loc. cit. supra* note 101.

[105]There have been a number of proposals for remedying this situation. See, for instance, the article by Cassius M. Clay, *The Case for a Special Railroad Reorganization Court* (1940) 7 LAW AND CONTEMPORARY PROBLEMS 450-455, n. 25; also the discussion of the preliminary drafts of the so-called McLaughlin Bill and Wheeler-Truman Bill in Swaine, *loc. cit. supra* note 101.

December, 1937	—Hearings held before the Commission, after the interested parties had filed objections and briefs relating to the examiner's report.
August 12, 1938	—Commission's report and order (approving a plan) filed.
November 28, 1938	—Hearings on the Commission's plan held before a Special Master appointed by the Court.
April 15, 1939	—Special Master's report on the plan filed.
October 30, 1939	—Plan approved by District Court.
October, 1940	—Argument on appeal from District Court's order approving plan.
February, 1941	—Decision of District Court affirmed by Circuit Court of Appeals, Sixth Circuit.

Thus eight years have elapsed and the reorganization is not yet completed.

One of the major questions presented in the Akron, Canton & Youngstown appeal was whether the Commission's failure to make specific findings in its report on the plan was a fatal defect, the appellees contending that any such defect had been cured by the findings of the special master appointed by the court. Their argument in this connection was that the function of the District Court is not that of an appellate court but rather that the court has original jurisdiction and full concurrent responsibility as to the plan.

Another question raised in this reorganization was whether the chairman of one of the bondholders' committees could receive compensation for his services rendered from 1933 to August 1935, when Section 77 was amended to preclude committee members from receiving any allowance for services.[106] Since the services were rendered before the change in the law, the Commission was persuaded to fix a maximum allowance for the services rendered during this period and the court subsequently granted such allowance. Considering all the safeguards now surrounding the granting of allowances under Section 77, it would seem that there is no necessity for the 1935 amendment precluding committee members from receiving any allowance, especially since small holders have no means of being effectively represented except by committees.

Because of the long drawn out procedure required, even after a plan has been approved by the Commission, a practical problem is often presented as to how payments of interest may be continued on fully secured bonds *after* the effective date of the Commission's plan. In the Akron reorganization,[107]

[106]Section 77(c) (12), as amended, expressly permits an allowance to committees for expenses incurred, but does not include committee members in the parties entitled to an allowance for services.

[107]Here from time to time, prior to the effective date of the plan (October 1, 1938), the court had authorized the payment of current interest to the Akron bondholders.

the problem was met by obtaining a court order directing payment on the old bonds in an amount equal to interest accruing on the new securities, such payment being made upon tender of the old bonds for stamping thereon of a legend referring to the Court order and containing an authorization to the reorganization managers (if the plan were consummated) to detach appropriate coupons from the new bonds issuable in exchange for the old bonds. As a result, the Akron bondholders are now getting currently the same amount by way of interest that they would have received had the Commission's plan been consummated on its effective date, October 1, 1938, and had they received the new securities at that time.

The problems which must be met in handling railroad reorganizations is well illustrated by one of the provisions in the Akron, Canton & Youngstown plan. As a result of certain mergers and assignment, the New York, Chicago & St. Louis Railroad Company (the Nickel Plate) had a contingent claim against the Akron of about $3,000,000, such claim having arisen by virtue of an indemnity agreement to save the Nickel Plate harmless on its guaranty of the Northern Ohio Railroad Company Bonds. Under the plan approved by the Commission, also approved by the District Court and affirmed by the Circuit Court of Appeals, this contingent liability of the Akron was disaffirmed, the Nickel Plate being tentatively treated as one of the unsecured creditors to the extent of the maximum $3,000,000 liability. Since only $850,000 in stock of the reorganized company was available for all unsecured creditors and stockholders, the plan provided that new stock would be issued and delivered to the other unsecured creditors only to the extent of the minimum amount they would receive if the Nickel Plate's claim was allowed in full. However, it provided that they were also to receive warrants under which, if the Nickel Plate claim should be determined to be less than $3,000,000, they would receive a correspondingly increased amount of stock. The stockholders were given Class B warrants entitling them to any common stock left over.

The plan further provided that upon proof by the Nickel Plate to the treasurer of the reorganized company of the amount of its ultimate loss (in responding to its guaranty on the Northern Ohio Bonds), the Nickel Plate and the other unsecured creditors would receive the additional stock in the proper proportions. Such an arrangement was necessary because Nickel Plate's loss depended on the difference between the value of the new securities going to the Northern Ohio bondholders in the Akron reorganization and the principal amount of their old bonds plus interest, which loss could not be determined at the time the Akron plan was approved. Although a constructive solution of the problem, this provision of the plan had the unusual consequences of requiring someone other than the reorganization court to determine the quantum of the Nickel Plate claim at a future date, and also of postponing the final disposition of the rights of creditors until the happening of events which might theoretically take years to determine.

Probably the major difficulty in all large railroad reorganizations is that of arriving at a satisfactory formula for the allocation of new securities as between the different mortgage divisions. In the Chicago and North Western Railway Company reorganization, the allocation of new securities to several of the mortgage divisions was based solely on the so-called "severance studies" (that is, determining the value of the particular divisional line on the basis of the net loss to the system if that line should be severed) and giving no weight whatsoever to the earnings results under the so-called "segregation formula."[108] In the case of some of the mortgage divisions, both the segregation studies and the severance studies were used, the weighting depending on the particular circumstances. On the other hand, in the Rock Island reorganization, in the plan approved by the Commission the segregation formula has been made the primary basis for the allocation of new securities, with certain adjustments and so-called "block allotments" of securities to cover the strategic value of a line or other special situations.

Where there is an unusually large number of mortgage divisions, the difficulty of agreeing on a satisfactory formula becomes almost insuperable. For instance, in the Seaboard Air Line Railway reorganization there are 26 different mortgage divisions, including leased lines, 13 of which divisions, according to the formula currently followed, show actual deficits. Since some interested parties believe the usual earnings formula would not serve the purpose in such a case, attempts are now being made to work out a reorganization formula giving appropriate weight to earnings and the balance of the weight to property valuation. Another suggestion has been made that the allocation of new securities should be based on net-ton miles of revenue freight per mortgage line; but one of the disadvantages of this method is that different rates are paid for different types of freight. It is interesting to note that the Seaboard has been in equity receivership for about ten years, the present program being to try to work out a satisfactory plan before going into Section 77 for the purpose of consummating such plan.[109]

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[108]There are few, if any, instances in railroad reorganizations where, for some of the mortgage lines, severance studies were used exclusively without giving weight to the earnings formula. The District Court has approved the Commission's plan and appeals involving this question are now pending.

[109]This was substantially the procedure followed in the pending reorganization of the Florida East Coast Railway, which went into equity receivership in the federal District Court in Florida in September, 1931. The so-called Anderson Plan was filed by the major bondholders committee in September, 1940, and at the hearings thereon the court expressed doubt as to whether it had the power to bind the minority interests. The plan was then filed with the Interstate Commerce Commission. Accordingly, proceedings with respect to the plan are now being held before the Commission under Section 77 of the Bankruptcy Act. It may be noted, however, that another plan, the so-called duPont Plan, has also

In connection with the pending appeals in the Chicago and North Western reorganization, a very interesting difference of opinion has arisen between the Commission and the District Court. Since the printing of the voluminous record on appeal would involve a substantial cost, the debtor applied to the Commission (Division Four) to have a maximum allowance for its out-of-pocket appeal expenses fixed in advance, the actual amount within such maximum to be fixed later by the court and paid out of the debtor's estate. The bondholders' committees opposed the application, contending that the Commission did not have power to fix maximum allowances for expenses that had not already been incurred. They also pointed out that it could not be determined at the time whether the appeal would benefit the estate. Division Four of the Commission refused to fix a maximum allowance.[110] The debtor thereupon filed a petition in the District Court for "equitable relief." Although the court indicated that it probably did not have power to grant an allowance unless a maximum was fixed by the Commission in accordance with the express provisions of Section 77(c) (12), it took occasion severely to criticize the Commission for its decision, Judge Barnes stating as follows:[111]

> "Now, I think it is exceedingly bad judgment—the Commission and this Court are said to have cut off values of $250,000,000. Now, it is desirable that the Court and the Commission not only do right, but that they seem to do right, and one way to make the actions of courts and commissions seem to be right is to allow appeals. One way to allow appeals is to make them possible by allowing expenses.
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> " . . . and I think it is exceedingly bad judgment unless we not only do right, but also appear to do right; and I think when we throw obstacles in the way of appeal such as this, we are failing to do everything we can do to further appeals, and failing to appear to do right."

On petition for reconsideration, the full Commission affirmed the decision of Division Four, denying the debtor's petition, but "without prejudice to renewal of the petition at such time as the debtor is prepared to show actual expenses incurred and the resulting benefit to the estate." Chairman Eastman and Commissioners Porter, Aitchison and Alldredge dissented vigorously.[112]

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been filed with the Commission, the Anderson Bondholders' Committee having recently announced its opposition to such plan.

[110]Report and Order of the Commission (Finance Docket No. 10881), dated January 14, 1941.

[111]In the Matter of Chicago and North Western Railway Company, Debtor (No. 60448, pending in the United States District Court for the Northern District of Illinois, Eastern Division), printed Court Record, p. 4883.

[112]Report and Order of the Commission, dated March 11, 1941. The debtor also made another motion for "equitable relief" in the District Court, which motion was denied, the court however again criticizing the Commission's majority decision.

VIII. Possible Amendments to Chapter X[113]

It is certainly too early to undertake any revision of the Chandler Act. It would be far preferable to have a much larger body of precedents under it. There are, however, a few amendments which possibly could be made.

1. Provision should be added to Article VI to the effect that where the court finds that the petition has been filed in the wrong jurisdiction by reason of the principal place of business and principal assets being located in another district, instead of dismissing the petition it may transfer it to the proper district, where the proceedings would continue as though originally filed there. It is obviously absurd to dismiss the proceedings and require a fresh start where all of the facts requiring reorganization are present and a mistake has been made only as to venue. This was brought out very clearly in the McKesson & Robbins reorganization where several answers were filed claiming that the proceedings should have been instituted in Connecticut. Until this question is disposed of many merchandise suppliers may well be reluctant to sell to the trustee as they are not sure of their status in event of a dismissal of the petition.

2. The last sentence of Section 156 with respect to an additional trustee is ambiguous. It is not clear that an officer of the debtor may be appointed even though he is likewise a creditor or stockholder. Of course, if this is not permissible, the provision is valueless inasmuch as in practically every case the officer would be a creditor to the extent of his accrued salary and in most cases would be a stockholder. Furthermore, the limitation "for the purposes specified in Section 189 of this Act" is not clear. While it is obviously intended that the additional trustee should have no part in the formulation of the plan, etc., there is still doubt as to whether he should not join in petitions, reports and other official documents. There should be a provision permitting the court to limit and define the duties and powers of the additional trustee. Perhaps the best solution would be to eliminate this provision entirely since the same result can be obtained by having the trustee appoint an officer of the company as his executive assistant.

3. Section 249 absolutely disqualifies a fiduciary from receiving an allowance if he has purchased or sold any claims or stock. The discretionary power of the court extends only to other acquisitions or transfers such as by inheritance, gift, etc. This might work a hardship on a substantial security holder who has served upon a committee and who might find it necessary to dispose of his holdings for personal reasons entirely disconnected with any inside information obtained by him through his committee membership. The

[113]The various proposals to amend Section 77 are fully discussed in Swaine. *loc. cit. supra* note 101.

requirement that any such sale be approved by the court should be adequate protection against unfair trading by insiders. The same argument does not apply to purchases of stock inasmuch as there can be no sound or compelling reason for a fiduciary to buy securities or claims of the debtor instead of making other investment of his funds. Even there it can be argued that a committee member or other fiduciary should be able with the knowledge and approval of the court to buy out a dissatisfied holder's securities or to buy securities in order to contribute them to the reorganized corporation.

4. Section 264 does not clearly exempt from registration under the Securities Act of 1933 securities which are issued in the first instance for property and then delivered pursuant to the plan for securities of or claims against the debtor. For example, a debtor might transfer a part of his property to a new corporation in exchange for all of the latter's preferred and common stock and deliver the preferred stock of the new corporation to its own creditors, retaining the common stock so that the new corporation would continue as a subsidary. There is clearly the same reason for exempting such a transaction as in a case where securities are issued directly by the debtor to its creditors. While it is believed a transaction such as here outlined is exempt under the present section, a clarification would be helpful. Furthermore, while this section exempts securities issued pursuant to rights to subscribe given to creditor and stockholders of the debtor, it does not permit an underwriting of this offer. Presumably the money to be realized pursuant to these rights is essential to the consummation of a plan and, accordingly, if an offering is not underwritten the plan may fail of consummation. There would be a great tendency, however, because of the reluctance of officers and directors to take personal responsibility for information with respect to the affairs of an issuer while under the control of a trustee or receiver to offer non-underwritten securities rather than to incur the expense and delay of registration. This defect could be remedied without changing the requirement that securities sold outright to or through an underwriter, must be registered.

5. Section 268 properly provides that a debtor shall not be deemed to have realized taxable income by reason of the modification or cancellation of indebtedness. Section 270 was intended to provide that in event of relief under this section, the tax base should be correspondingly reduced. However, it is so broad that it would cause a reduction in the tax base even though the transaction would not have resulted in taxable income to the debtor irrespective of Section 268, the net effect being to penalize rather than to assist a debtor. The problems in this connection have been only partially met by the 1940 Amendment to the Bankruptcy Act.[114]

[114]PUB. LAW No. 699, 76th Congress, Third Session (July 1, 1940). See generally

6. Section 216(12) (a) is not clear as to whether or not preferred stock can be issued which votes only in case of default. It might be construed as requiring the preferred stock to vote at least share for share with the common, irrespective of default. Suppose it were permissible under state law to permit bondholders to vote. And assume further that the plan provides that until interest has been paid on the bonds for two years in succession the bondholders have the right to elect the board of directors. Is this a violation of the provision that non-voting stock may not be issued?

Could the provisions be satisfied by giving the preferred the right to elect a certain number of directors (1) at all times or (2) a greater number in the event of default? If the preferred stock provisions were to provide that in the event of, say, eight defaults, the preferred would have exclusive right to vote for directors, would this constitute violation of the Act on the ground that the common stock would be temporarily non-voting? Must the preferred have right to vote on (1) increases in the common stock, or (2) changes in the par value, or (3) reduction in capital with respect to the common stock? Does this mean that voting cannot be by classes so that one class of preferred must have the right to vote on something affecting only another and different class of preferred? Or does it mean that all voting must be in the aggregate rather than by classes? If so, must there be a proper relationship between the common and the preferred stock so that the preferred does not in effect become non-voting by reason of the greater number of common shares?

7. Section 198 provides that the indenture trustee may file claims for all holders, known or unknown, of securities issued pursuant to the instrument under which it is trustee (who have not themselves filed claims) but that in computing the majority necessary for acceptance of the plan only the claims filed by the holders thereof will be included. In other words in a $10,000,000 bond issue if the trustee filed on behalf of all holders and claims were filed only by the holders of $1,000,000 in principal amount thereof, the plan could be assented to by two-thirds of $1,000,000 or less than 7% of the total. Professor Gerdes[115] suggested as the reason for this provision that securities under trust indentures are often payable to bearer, many of the holders being frequently unknown, with the result that it might be very difficult to obtain the requisite assents if the trustee could file on behalf of all holders. It would seem that the statute could at least provide that a plan could not be put

on this subject Darrell, *Discharge of Indebtedness and the Federal Income Tax* (1940) 53 HARV. L. REV. 977; Warren and Sugarman, *Cancellation of Indebtedness and Its Tax Consequences* (1940) 40 COL. L. REV. 1326 and (1941) 41 COL. L. REV. 61; Surrey, *The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness* (1940) 49 YALE L. J. 1153; Paul, *Debt and Basis of Reduction under the Chandler Act* (1940) 15 TULANE L. REV. 1.

[115]Gerdes, *supra* note 32, at 33.

through against the dissent of one-third of the bondholders, provisions such as this having been found constitutional in state reorganization statutes. Since the courts have usually allowed introduction of stockbooks and stock records as sufficient proof as to who are stockholders at a particular time without requiring each stockholder to prove the number of shares he owns, it is obvious that it is an anomaly to require that a majority of stockholders file their assent and allow proof of their holdings to be made in this manner but to treat bondholders as does Section 198.

8. It is also probable that some change will eventually have to be made in Section 243, the so-called "Christmas tree" provision as to granting of allowances. The effect of this section is to invite applications for allowances by all interested parties, with the result that the allowances granted must be "spread very thin," which in turn may mean that those who do most of the constructive work actually receive rather meagre compensation. It is not clear as yet how this provision will work out in practice and whether in the long run it will aid security holders of financially ill corporations. If this section tends to discourage able and competent members of the bar from serving in this field, it will not aid security holders. It may well be that the courts themselves will recommend that some restriction on those entitled to seek allowances be made. Fees should bear a greater relationship to what is accomplished for the security holders. Attorneys, in this capacity, are "officers of the court" and as such are entitled only to reasonable compensation.

IX. Conclusion

As you will have gathered from the emphasis on the historical antecedents of Chapter X, it would seem that any lawyer engaging in corporate reorganization practice today must of necessity go back to the old federal equity receivership principles in order to get a clear understanding of the present law. It is more than just acquiring a "background." In large measure, Section 77B and Chapter X are merely codifications of these old equity principles.[116] Thus, Chapter X expressly grants to the bankruptcy court, in addition to the bankruptcy powers conferred, "all the powers, not inconsistent with the provisions of this chapter, which a court of the United States would have if it had appointed a receiver in equity of the property of the debtor. . . ."[117]

[116]See Finletter, *op. cit. supra* note 5, chapter 1. Finletter states at p. 3 in this connection: "The principles of the equity receivership underline nearly every substantive provision of the new amendments." And see quotation from *Duparquet Co. v. Evans, supra* note 21 and connected text.

[117]Section 115 of the Bankruptcy Act of 1938. See also Section 187 providing that the trustee, if authorized by the judge, "shall have and may exercise such additional rights and powers as a receiver in equity would have if appointed by a court of the United State for the property of the debtor."

In general, it may be said that the enactment of Chapter X together with the enactment of the Public Utilities Act of 1935, has completed the evolution of increasing judicial and administrative control over reorganizations, the supervision and responsibility of the court, through its trustee, extending now to the formulation and filing of a plan. It is interesting that this eventual result was envisaged as early as 1922 by Charles T. Payne of the New York and Connecticut Bars in his article on "Administration of Equity Receiverships."[118]

The new bankruptcy legislation has gone a long way in achieving its major objective of protecting the small independent investor, providing a disinterested trustee, making available impartial advisory reports, removing those interested in the emoluments of "control" from the playing of important roles in reorganizations, and placing greater control in the hands of the court. These results are good and constructive.

In so doing, it has added many more steps to the reorganization process and it is arguable that it has increased the expenses and delays involved. The law may also have increased the possibilities of obstruction. As Professor Gerdes has pointed out,[119] the supplying of safeguards to prevent overreaching and to protect independent investors is only one of "two forces at play in the evolution of devices for corporate reorganizations." The other equally important force has been "toward the development of a simpler, less troublesome, and less expensive procedure, so that corporations requiring such relief could take advantage of reorganizations without encountering obstacles of too serious a nature."[120] In Section 77B this latter objective played a predominant part. In Chapter X and in the judicial construction of the chapter the pendulum seems to have swung the other way. The *Los Angeles Lumber Co.* and *Consolidated Rock Products Co.* cases will take their places with the *Boyd* and *Monon* cases as milestones in reorganization history.

The elimination of committees is not an unmixed blessing. In eliminating management, despite their conflicting interests, common stockholders lost one of their stoutest champions.[121] In fact it may leave the small security holder at the mercy of large institutional investors who can afford to retain able counsel to represent their interests with the individual holders unrepresented except by the trustee and the advisory reports of the Securities and Exchange Commission.

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118 31 YALE L. J. 685, 701.

119 Gerdes, *loc. cit. supra* note 32, at 38.

120 *Ibid.*

121 See the very interesting comment of E. Merrick Dodd in *The Securities and Exchange Commission's Reform Program for Bankruptcy Reorganizations* (1938) 38 COL. L. REV. 223, 268, 269, written before the law was passed but penetrating in its analysis of the effect on reorganization procedure.

Large investors have been discouraged from acting in representative capacities and able and honorable men well versed in the technique of reorganizing corporations often hesitate to lend their names to reorganization programs because of the general obloquy and contempt in which committees are apparently held by federal agencies. Experience has shown that small security holders either do not or cannot reorganize effectively. Independents without any stake in the corporation who are sometimes willing to serve are usually not sufficiently experienced in negotiations or in all of the steps which must be promptly and vigorously taken in order promptly to reorganize a corporation and to return it to its security holders with the proper capitalization and in good operating condition. Security holders may well lose more by long drawn out reorganizations than they would in prompt and effective reorganization even though some classes of security holders may receive more than they are justly entitled to. It is of course important that fiduciaries who have been guilty of wrongdoing should be punished. But it is equally if not more important to the securityholders that, apart from the social consequences, such suits should not be accomplished at the expense of unduly delaying the reorganization. The purpose of reorganization is not litigation or punishment but is to get the company back on its feet and starting to earn money again for its security holders.

It is still too early to say, but with a few more year's experience in Chapter X reorganizations it may become evident that some of the reforms have been accomplished at too great a sacrifice of purely practical requirements. It is rash to predict, but it is possible that the next comprehensive set of amendments will be directed towards simplification of procedure, with the emphasis again on "debtor relief" provisions.

It behooves us as members of the bar, and officers of the court, not to worship blindly at the altar of past practices but to keep our minds open and alert to the sociological and economic changes that are going on all around us. Thus, we may continue to be able not only to serve our clients well, but also to serve a useful social function in working with the courts and agencies, such as the Interstate Commerce Commission and Securities and Exchange Commission, in improving and perfecting the bankruptcy and reorganization statutes, plans and decisions. Reorganization is a changing and evolving process. What is true today will I am sure not be true tomorrow.